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CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1987

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

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CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1987

WEDNESDAY, FEBRUARY 5, 1986

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, in room SD-630, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kassebaum, Boschwitz, Andrews, Symms, Grassley, Kasten, Quayle, Gorton, Chiles, Hollings, Johnston, Sasser, Hart, Metzenbaum, Riegle, Moynihan, Exon, and Lautenberg.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and John Hilley, senior economist.

Chairman DOMENICI. Could we have order, please.

All right. The Budget Committee will to order. Let me talk with the committee for just a moment about the procedures here today. Even though we do not have a lot of time, I understand everybody wants to participate, and the Director has to leave, if it is at all possible, by 5:20 p.m., 5:30 p.m., something like that. That might even be a little late for him.

If you will cooperate with me, I will change the roles here, and let everybody make a brief opening remark.

I would urge that they be very brief, so that we can move immediately to the Director, and then have some time for questions.

If that is satisfactory, the chairman and the ranking member will make their opening remarks, and then I will call on any Senator that wants to make remarks. I will not hold you to it, but I would like your opening remarks to be limited to 1 or 2 minutes. Then we will have an opportunity to hear the witness.

If you will permit me, however, I will make a statement that will take longer than the rule.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. Since a lot is being attributed to me at this point, I would like to take this opportunity, in the presence of the Director, and the members of my committee, fellow Senators, to tell you where I stand. First, let me say I am very pleased to welcome, once again to our committee, the Director of the Office of Management and Budget, Jim Miller.

You were here just 2 weeks ago to discuss the role of the OMB in the first Gramm-Rudman-Hollings sequester process.

DIRECTOR OF OMB GIVEN IMPOSSIBLE TASK

As I told you then, you have had to do a lot in your first 4 months on the job. It is a tribute to your skill, and energy, and dedication, that you and your agency have been able to meet all the deadlines and perform in a highly professional manner.

Now you present to the Congress your first budget on behalf of the President of the United States. With your permission, I would like to repeat here, in public, what I have told you and other members of the administration, recently in private.

In my opinion you were given an impossible task. You were told that you could not increase taxes in order to reach the deficit target that is now in law.

You were told that very large portions of the domestic budget were off limits. You were either told that by Congress or you were told that by the President.

You were told that you had to increase defense spending above last year's levels, and you were told to find all the savings you had to find through cuts and reforms in the remaining domestic programs. I must say, right up front, that is a mighty tough job.

THE IMPOSSIBLE ACCOMPLISHED

Yet, the President's fiscal year 1987 budget, if its assumptions and policy assessments are accurate, does exactly that. The budget that you bring before us is a set of policies that, if fully implemented, and would reach the deficit of less than $144 billion in fiscal year 1987, and that will lead to a balanced budget by fiscal year 1991, assuming the assumptions that you have made.

It provides for a defense spending increase of $34 billion in fiscal year 1987. As I said before, it requests no new taxes of any significant amount.

Now, obviously, some will argue that there are some taxes such as the cigarette tax in the budget. The President's budget puts off limits Social Security and several programs for the truly needy. It recommends a large cut in domestic spending, and as I understand it through your staff—and you might correct me if I am mistaken, Dr. Miller—the elimination of approximately 90 domestic programs, large and small.

It embarks on an intriguing notion called privatization. While far less in scope than some had speculated, nonetheless it starts down that path, and that deserves our attention. It calls for some increases in collections through asset sales, user fees of a wide variety and range. The President, and you, cannot be accused by anyone of having failed to make a coherent and good faith recommendation on this budget.

Yet, I must say to you and to the members of this committee, that this is a different year from all others for this committee, and I believe for the Congress.

This year, a bell will toll if Congress and the President fail to agree on a fiscal package and implement and carry it out.

If we do not act, the Gramm-Rudman-Hollings mechanism will act for us. I believe such an outcome, though it may be likely, would be a tragedy for this Nation and for our allies, and for what we stand for in this world.

Therefore, I will do all I can to see that that does not occur. You know, I have sometimes thought, that if I were a dictator of the legislative branch, and the President were a dictator of the executive branch, we could make a deal. We could do that in short order.

We probably could cut domestic spending, increase defense spending, and still reach our deficit targets. But I do not think there are any doubts that I am not dictator of the legislative branch and, enormous as the President is in power, he still has to deal with Congress under our democratic system.

Therefore, I was greatly encouraged by the President's public plea last night to the Speaker of the House, Mr. O'Neill, that we work together this year.

We need a solution that does not just satisfy the chairman of this committee and the President of the United States alone. We need a solution that will get a majority of support in the U.S. House and in the U.S. Senate, and from you and our President.

REVENUES NEEDED

That solution, in my judgment, will need a revenue component to glue it together. I want to quickly look at your recommendations, Dr. Miller, on behalf of the President.

ELIMINATION OR REFORM OF DOMESTIC PROGRAMS

You wish to eliminate Amtrak, Small Business Administration credit programs, urban development action grants, the Appalachian Regional Commission, the Economic Development Administration, the Interstate Commerce Commission, the Work Incentive Program, and others.

You wish to have a very large-scale reform again in Medicare, in civil service pensions and health benefits, postal subsidies, interstate highway grants, and in many other areas.

Well, I do not want anybody to misunderstand. I have been at this for a long time. I fought for almost every one of those. The President has made similar recommendations for the past 2 years. But the Congress and the President have been unable to reach conclusions on them and they remain part of the American domestic programs.

So I have come to the conclusion that we are this year approaching, from the budget standpoint, that period that we might call the "last resort" budget.

It is clear that we cannot get a meaningful deficit reduction package without substantial domestic cuts, which would be far less onerous than the Gramm-Rudman-Hollings automatic sequestration cuts, and I conclude, without some revenues.

TAX INCREASES RATHER THAN SEQUESTRATION CUTS

I think taxes could be the glue that would put this package together. I wish I did not have to say this. Each of us have examples of other leaders and other legislators in this country who have had to do the same.

In my State, the Republicans have had to propose a budget with some increases in taxes because they must balance the budget. So, we have a job to do just like they do.

By your calculations, we have to find at least $38 billion—if I understand it correctly—in deficit reduction measures, not all cuts, but measures—to reach the $144 billion target. I believe that other estimates, and perhaps those that we will adopt as a committee, will put that needed package closer to $45 billion. I am hopeful it will not reach $50 billion.

But let me make it clear for everyone that is interested out there in America, that a sequester order in September, of the magnitude that I have just described, would demand $20 billion from defense and $20 billion from nondefense, more or less.

These would be cuts, not user fees or asset sales. Even the President's budget attempts true spending cuts, and eliminations of $23 billion, if I read it correctly, in the domestic area. The President's budget asked for a $34 billion increase in budget authority for defense, not a $40 billion to $50 billion reduction, which would be the sequester order, if $20 billion in outlays were required.

So I believe the time is real and upon us, and there is no time left to play any kind of games. Now I hear some members of the other party, not on this committee—I refer to some Members of the U.S. House—saying that unless the President, in advance, relents on taxes, they will not play the game.

Well, I would reverse the coin, and ask if they are willing to take substantial domestic cuts. Again, I do not say that to my members, on either side, but to those who make statements like the one I just read. We need both parties, both bodies, and all of the players, as I see it, in this game from the very start.

INCREASE DEFENSE SPENDING

So I would like to conclude by recounting some history. This committee, Senator Chiles, Senator Hollings, on that side, and others who are still here, began the drive for defense spending increases right here, almost 10 years ago.

We were willing to slow the growth in domestic spending to pay for defense. I am still willing to do that. I am also willing to pay for the defense and nondefense spending that remains after restraints and eliminations, speaking only for myself, at this point.

I think we need a defense increase because we have to be responsible, and we need many domestic programs because we have to be humane, and we need money to pay for them because we have to be fiscally sane. So I do not want anyone to make any mistakes.

If the Court finds Gramm-Rudman-Hollings constitutional—and I hope they do—then we will not be able to walk away as we have done in the past. If we do, we will be, all of us, answerable to the American people for the chaos that is going to follow.

So if this committee leads, and if we can reach agreement among a majority of us, then the rest of Congress, and maybe even the President may join us. If we fail to lead, I fear disarray. I think we need the President on board, and we need to join him in some kind of collaborative effort.

I think we need a summit with the President and congressional leaders meeting to solve this. Only if we on this committee push hard and effectively will such a summit occur.

Now, Senator Chiles, I yield to you, and then I will take the Senators in order.

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Thank you, Mr. Chairman. Good afternoon, Dr. Miller, and welcome to the Budget Committee.

Mr. Chairman, I have long been an admirer of yours, but I am more so today. I congratulate you for speaking frankly, and forthrightly, what I think is on your heart, and saying, publicly, what you have felt to be the case for a long period of time. I think that is going to be helpful.

I think it is time the things said in the back rooms need to be said in the front, because, as you say, we are under the "guillotine" of Gramm-Rudman-Hollings. If we fail to come up with a budget package, I trust we are going to try to see that we come up with a package so that that does not happen.

I will have to say, Dr. Miller, I felt a lot better last night, when I listened to the President's themes than I feel this morning now that I have seen the blueprint, and see how we supposedly get there.

But I am encouraged by some things, and I certainly should speak to that. To begin with, the President's budget is at least in technical compliance with the Gramm-Rudman-Hollings legislation. That is evidence, to me, that you all are serious about deficit reduction.

For another thing, I was impressed last night by the hopeful note the President set in his State of the Union Address. I think you will find that those of us in the Congress are eager to reach the goals of a strong and growing economy, and know that it is the key to success in a competitive world

PRESIDENT RECEPTIVE TO OIL IMPORT FEE

Now what we have to do, the public, the White House and the Congress, is get together on the best way to get that job done. But it is at that point some questions come up that bother me.

If recent news stories are a guide, it now sounds as if the President is more receptive to an oil import fee. The trouble is, he does not appear to want to use any of those revenues to reduce the deficit. Rather, in his own words, or in the words that were quoted in the paper, he wants to offset some of the loophole changes.

It seems to me if the President went along with a tax on foreign oil alone, domestic oil producers certainly would raise their prices to a level just short of the imported oil, and reap a windfall. And if, as the President says, the foreign import fees are just used to offset loophole changes, like maybe oil depreciation, then domestic producers would be the winners.

You end up saving tax breaks for the oil producers while jacking up their profits at the same time. That makes them double winners. The loser, then, would be the American consumer.

What have the tax cuts meant to the family in the middle? Maybe $150 to $200 a year in their pockets. Would it be fair to take that money back, not to cut the deficit that affects everyone, but to safeguard loopholes for the oil industry? I do not think so.

I think that is asking a lot of the American family without offering them anything in return. I think that is offering big companies a big return without asking them for anything. I guess deficit reduction comes down to a very basic question: Who bears the burden? Do we do it together, or, do some bend lower so others can stand taller?

DON'T GET OUR BACKS, TO THE WALL

I would have to say, again, the most heartening thing in the President's address last night was when he turned to Speaker O'Neill, and said, the budget is busted and we need to fix it, and you and I ought to sit down before we leave town.

I think that is terribly important. We should not let this wait till August until we are up against the deadline.

We are going to start on our work in this committee, and I trust the House is. Let's do it sooner rather than later. I think that is the note that you are making, Mr. Chairman, and I hope we can do it.

Chairman **Domenici**. Thank you very much, Senator Chiles. Now, might I ask which Senators desire to make brief opening remarks. Let's go on this side. Senator Andrews.

OPENING STATEMENT OF SENATOR ANDREWS

Senator **Andrews**. Thank you, Mr. Chairman. Dr. Miller, it is good to have you here, and I join my colleagues in saying that our hopes were raised when the President turned around last night and talked to Tip O'Neill, the Speaker of the House, and said, "We're going to have to work on this together, Tip." That means bipartisan type action. That is the only way that we can get the spending cuts across-the-board, and the revenue enhancement that we need, to truly get the deficit under control.

FAMILY'S IMPORTANT ROLE IN SOCIETY

I also of course was happy to listen to the President's emphasis in his State of the Union speech on families, and their important role in our society.

I am hopeful, Mr. Chairman, that the final resolution that we put through this commitiee, does reflect the importance of those programs that have long been the mainstays of support for our middle class and lower income families.

And I would hope that the Congress and the President can make that terribly important distinction between spending programs and investment programs.

Many programs important to the family in education, medical research, and all the rest, are truly investment programs that we need for the future of this country.

Now let me also point out, candidly, Mr. Chairman, there is going to be a lot of budget bashing before we get done with these hearings.

It is not going to be easy to put a budget together, even with that bipartisan support that some of us have been working for for a long time, and I have been known to vote, occasionally, with those fellows on the other side of the aisle, and maybe they have been voting with me. This is the way we have got to do it, but it does not come that easily.

PROMISES KEPT

Let me say, Dr. Miller, that you have not just slashed and trashed in putting this budget together. We have got a need up in my State and I am sure in other States, for a water project that is hung up waiting for an authorization, and I just want to say thanks, because you included, of course, in your justification, that you would make supplemental appropriations available if we got that authorization.

So the administration has kept faith with promises they have made and we appreciate that. This budget has to be put together, though, on the basis of the overall picture and accommodate the unique needs for investments in various programs, and I intend to work with my colleagues on this side of the aisle, and my colleagues on that side of the aisle, to get the best and the most responsive package we can, and we welcome your comments and your suggestions along the way.

Thanks, Mr. Chairman.

Chairman **Domenici**. Thank you very much, Senator. Senator Hollings.

OPENING STATEMENT OF SENATOR HOLLINGS

Senator **Hollings**. I thank you, Mr. Chairman. The note of bipartisanship should be remarked upon and continued. I congratulate Chairman Domenici.

When he took over in 1981, I had been the chairman, and the spending cuts for the Reagan administration came under the rubric of the Domenici-Hollings spending cut resolution. We have tried to continue the spirit of that. The distinguished Senator from North Dakota and I, just 1 year ago, submitted a bipartisen approach to that end, which I hope we can develop here.

Now let me take one minute to tell you how we approach our task here at the Budget Committee.

PROGRAM INCREASES

The first thing to remark are the increases, which have never been emphasized. There is not one sheet that really sets out the increases. Page 3-24 sets out the cuts, but it doesn't lay out the increases. Let's look down the list of the major increases: for defense a $16.4 billion increase; for Social Security, $12.1 billion; $10.8 billion in interest; $1.5 billion in Medicare; international affairs, foreign aid $1.5 billion; Postal Service, $1.4 billion; disability, $1.1 billion; unemployment compensation, $400 million; $300 million for income; NASA, $300 million; aviation safety, $200 million; drug enforcement, $200 million; REA and nuclear waste, $100 million. I am adding up, therein, some $46.5 billion in increases, plus the supplemental, requested in this budget, of $2.5 billion. So I am looking at a request of $49 billion in increases, and then I look at the requirements of Gramm-Rudman-Hollings and I have got to drop, under the CBO figure of $182 billion down to $144 billion. That is a $38 billion swing.

So much for increases. Now let's talk about growth. All Directors of the Office of Management and Budget use a rather rosy scenario relative to growth. They have been talking about 4 percent growth for 2 years. This last year, when they said 4 percent, the real growth turned out to be only 2.3 percent. This year OMB uses a 4 percent figure at the same time CBO predicts a growth of 3.1 percent, which tells me that you and I have another $19 billion difference there.

ALL CUTS AND NO TAXES

So I am taking the $49 billion, the $38 billion under Gramm-Rudman-Hollings, and the $19 billion, and that is $106 billion, and I am saying the President of the United States says now we've got to do it with cuts and no revenues.

I am looking, then, on page 3–24 to see what the President has cut, and if you look on that page it is a cumulative amount of some $38.2 billion. But to squeeze this much out, he has to cut social programs, instituted user fees, and wants to hold fire sales and going out of business kind of situations. The President of the United States, the famous cutter says to cut under low-income benefits, $700 million; other human and social services, $15.4 billion; and $6.3 billion under "Other," whether that is Amtrak, highways, rural housing. So he only finds $22.4 billion in cuts from the social programs. That is where I get the revenue picture.

No one is trying to shove taxes down anybody's throat. But if we don't do something about revenues, this deficit will be shoved back down our throats. Realistically, I have got me a $100 billion task, if we are going to comply with Gramm-Rudman-Hollings. The President himself finds $22.4 billion in domestic cuts and only $6 billion in new revenues.

So you can see, as I approach it and ask you the questions, why I am asking these questions in that context, because, realistically, Chairman Domenici is on target.

I do not see how you can get out of this without some kind of revenues, and we are not playing games about Alphonse and Gaston. We will recommend revenues. I did so in my budget last year and the year before last. The Senator from Nebraska running for reelection and the Senator from Michigan running for reelection had the fortitude to vote for revenues. They were high-tax folks, they were merely conscientious about this deficit. Thank you a lot, Mr. Chairman.

Chairman **Domenici**. Thank you very much. Senator Boschwitz.

OPENING STATEMENT OF SENATOR BOSCHWITZ

Senator **Boschwitz**. Dr. Miller, in my own little way, I am trying to help the effort of bringing about a balanced budget by getting the administration, the House and the Senate together, in advance, so that we can agree on what should be done to avoid a sequestration.

I agree with Senator Chiles, that a sequestration would have very adverse consequences, not only for defense but for a number of important government programs.

CUTS WILL REOCCUR IN OUT-YEARS

Furthermore I note that with the $11.7 billion cut, the way the budget is projected and constructed, that $11.7 billion cut, through sequestration, the amount that occurred this year, is going to be projected out and will reoccur in the out-years.

Therefore, if we make a cut in fiscal year 1987, prior to sequestration, it too will be reflected in the out-years. It will be cumulative, and we will have about $50 billion worth of cuts in the third year.

I think that if we achieve Gramm-Rudman this year we will have achieved Gramm-Rudman, period.

That is why the budget process in 1986 is of such great significance, because of the reflection in the out-years of the cuts that we make in this year.

If we get the $11.7 billion plus about $40 billion this year, we may even exceed Gramm-Rudman in the out-years and that would be very welcome news indeed.

I think it will have very positive effects on the economy and all the other things we have been talking about up here for years. Because of that, I am doing my best to try to compel the White House and the leadership of this body, and the leadership of the House to get together soon for the purpose of working out a plan that will be accepted by a broad array of membership on both sides. But this is the critical year, because of the reflection into the out-years of whatever is done this year. If we achieve it this year, we are indeed going to head very rapidly for a balanced budget, more rapidly even, in my judgment, than Gramm-Rudman demands. Thank you, Mr Chairman.

Chairman DOMENICI. You are an optimist. Senator Johnston.

OPENING STATEMENT OF SENATOR JOHNSTON

Senator JOHNSTON. Thank you, Mr. Chairman. Dr. Miller, I must say I do not share the enthusiasm and the congratulations, and the optimism that some of my colleagues do.

I see nothing in this budget, in the State of the Union, or in the state of affairs of this country, that calls for anything but unremitting gloom.

PRESIDENT AND CONGRESS MUST FIND COMMON GROUND

I voted against Gramm-Rudman because I could see a scenario playing out where the President, strongly committed as he is to national defense, would come in for further increases in national defense; no cuts in Social Security; no increases in taxes; and otherwise would submit a budget which the Congress could not accept, and would in effect draw the line in the dust.

I have heard the line in the dust drawn. On the radio the other day he said: "Make my day; send me a tax bill." He has said it is absolutely essential to have a defense increase, and so he sends us a 12 percent, $33 billion increase, and I just do not see where the dialog starts, I mean, where we have the common ground.

I do not know who it was that first described it as "a train wreck getting ready to happen," but it looks like, to me, these trains are locked in high gear and headed full speed, and we are congratulating one another on working hard and doing a good job, but where is the negotiation?

I mean, you think we are really seriously going to negotiate about salvaging education, health, all of those programs, while increasing foreign aid about one-third on top of, I think it was 28 percent last year, and increasing defense $33 billion? I mean, that is just not going to happen, and that is no way to start a conversation.

I mean, if we are going to have a settlement of this thing you are going to have to involve—I think you are going to have to involve me. I have been on the bipartisan groups before and am willing to be again, and am willing to, as President Reagan said, "take the heat."

But we have got to start a conversation somewhere. I just do not see it starting.

Chairman **Domenici**. Thank you very much, Senator. Senator Kasten.

OPENING STATEMENT OF SENATOR KASTEN

Senator **Kasten**. Mr. Chairman, thank you. I, too, am pleased that the President is delivering a budget that is within the requirements of the Gramm-Rudman-Hollings legislation—that the budget is within the deficit cap of $144 billion—and I also hope that Senator Boschwitz is correct, when he says that if we make the difficult choices this year, it is going to make the job of the coming years easier.

It is clear that the burden has now shifted to us in the Congress, and although I disagree strongly with some of the provisions that are contained in the proposal, it is my hope that we in this committee, and also that the Senate and the House work to reorganize the priorities before we begin to work on revenue increases as part of the budget process.

I hope that the revenue increase debate will take place not within the context of the budget resolution here, but if necessary, that that debate will take place in part of the tax reform context which is going on in the other committee.

JUMPING TO REVENUE INCREASES A MISTAKE

For us to right now jump and to start, use the oil import fee, or other kinds of revenue increases, at this point, before we have tried to reorganize our priorities, I think would be a mistake; and here, our job ought to be to concentrate on the priorities, and then, if we are unable to resolve those differences, fight them through with the House of Representatives.

But I hope we do not bring the tax reform debate in on top of the budget debate, and end up with a stalemate on everything, and I think that it is possible that that is where we could be heading.

Someone said we ought to start to talk "out front" in some of the discussions that we have been having amongst ourselves.

Well, there are all sorts of little buzzing going on about how we can increase taxes right now and get in on tax increases early in the process.

I think we would be making a mistake if we get in on tax increases early in the process before, No. 1, we have concentrated on reducing the rate of growth of Government spending, and, No. 2, we have thrashed out our arguments between the House, the Senate, and the administration, on the basic questions of priorities.

The priorities are different; there are going to be changes. But that is where I hope we will address our concerns over the next several weeks.

Chairman DOMENICI. Thank you very much, Senator. Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman. Dr. Miller, the budget prescription contained in this budget is premised on two key and important assumptions. Perhaps the most important assumption is that we are going to continue to experience favorable economic growth, and that is going to have wrapped inside of it lower interest rates, low inflation, and low unemployment over the next 5 years. And the second assumption is that the current state of affairs in American society is desirable.

Well now, I surely hope that the first assumption, that we are going to continue to experience favorable economic growth, is an accurate one, and I think that the decisions that we make in the coming weeks, in the coming 2 or 3 months, are going to, in large degree, shape whether or not we do continue to experience favorable economic growth.

Now on the second assumption, that the current state of affairs in American society today is a desirable one, I frankly think that the cold hard facts belie some of the flashy rhetoric that we heard last night, that one of my colleagues characterized—I thought accurately, this morning—as "high political theater."

POLICIES HAVE FOSTERED A CULTURE OF DEBT

Our economic policies over the past 5 years have fostered a culture of debt. Both our budget and international trade deficits are absolutely horrendous.

We learned today in the Senate Banking Committee that the Japanese have now passed the United States as the bankers of the world. We are now second to them in one other avenue of economic endeavor.

We have doubled the national debt in a period of 5 years, and interest remains the fastest-growing component in the Federal budget.

Chronic unemployment remains a very serious problem. In my State we have counties in which unemployment is well over 20 percent.

In the Sun Belt State of Tennessee, we have lost over 50,000 jobs in the last 5 years to imports coming in from abroad.

And even with a fairly robust economic recovery, unemployment still hovers around 7 percent.

Now there is some data—in fact respectable data—that indicates that the middle class in our society is actually shrinking.

Families in the middle and lower end of the income scale are receiving the lowest shares of the national income pie, while the wealthiest 40 percent of U.S. families, are receiving the largest share ever recorded.

Nobody said much last night about what is happening to farm families all across this country, and the gap between lower and upper income continues to widen.

There are now almost 34 million Americans who live below the poverty line, and we hear continuing reports of widespread hunger across the country.

I saw just the other day a report that there are 3 million people living in this country today without shelter. So, I am not confident that a further shrinking of the Federal Government's responsibilities in these areas is warranted, simply on the basis of numbers, or deficit reduction.

SHOULD DEFENSE BE CUT?

I think that we have to look at all areas of this budget where we can cut. I think this includes defense. I favor a strong national defense. But as I read it, Mr Chairman, national defense receives a 12-percent increase in the current budget, superimposed on the largest military budget we have had in this country since the Korean war.

I look forward to trying to work with the chairman and the members of this committee to deal realistically with what I consider to be a grave fiscal crisis. Thank you.

Chairman **Domenici**. Thank you, Senator. Let me remind the Senators, if you would indulge me for a moment. A couple of Senators said they would like to make some brief opening remarks, so I changed the rules. Now we are having very lengthy opening remarks and we are hardly going to get around to a witness.

I am going to continue for a while. I would just ask you to save some of the remarks for the time when we have questions. If we do that we will all get a chance to do both. Senator Grassley, I think you wanted to be heard, and Senator Gorton on this side. All right. We have three. It looks like to me that five of you ought to be able to finish in 10 minutes. That will put us up there at 4:55 p.m., so let's just set that as a goal. You all watch it and help me with it. Senator Grassley.

Senator **Lautenberg**. Mr. Chairman, a question of procedure here. Those of us who do not make opening statements I assume will have that time added to our time during questioning.

Chairman **Domenici**. I will try to do that. I will average it out. Maybe it is 1½ minutes. I will add it to the 5 minutes everybody gets. I think that is a good idea and I appreciate the comment. Senator.

OPENING STATEMENT OF SENATOR GRASSLEY

Senator **Grassley**. Mr. Chairman, I would ask my colleagues on the committee to think defense. The ball is in our court now. The President has made his proposal. I hope on defense that we do not react, but that we act, and that we do that based upon our own information. We have got the resources to get the information, and if we do not, then there is something wrong with our decisionmaking authority.

DEFENSE HAVING PROBLEM SPENDING MONEY

I ask my colleagues to contemplate three or four things. First of all, I want you to try to understand the difficulties that the Department of Defense is having spending the money that we have already given them, money in the pipeline. I want you to be very confident, before we decide on defense numbers a couple of months from now, that the money is being spent as efficiently as it should be spent.

And also, ask yourself if the tremendous increase in unobligated balances is an alarm for you; I hope it will become apparent that the Department of Defense cannot obligate its budget, and that budget growth is therefore not needed.

Last, I hope that we can figure out that the best way to avoid a tax increase is not to ask for defense growth until the Department of Defense can spend what they have already been given by past Congresses.

Chairman **Domenici**. Thank you very much. I wonder if I might ask the staff, with reference to that, on both sides, if they might present for us a written assessment of what unobligated balances mean. Why don't you do that? I mean, I hear it means one thing and I suspect it means another. Maybe you could get us that and we might learn what it means, rather than assume it is all there to spend or not all there to spend, whichever the case may be?

Senator **Grassley**. Also, Mr. Chairman, make sure you include in that the growth of the unobligated balances as well.

Chairman **Domenici**. I will add that to the assessment. Senator Riegle.[1]

OPENING STATEMENT OF SENATOR RIEGLE

BUDGET PRIORITIES DAMAGING

Senator **Riegle**. Thank you, Mr. Chairman. Mr. Miller, I am very troubled about the priorities in the budget. I think they are going to be very damaging to the country and I think the people of the country will feel the same way when they understand what you are proposing here.

You are asking for a massive increase in defense spending, 12 percent, close to $35 billion in 1 year. You are asking for substantial increases in foreign aid.

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[1] See p. 108.

But very little has been said right now as to who is really targeted in this document, and as we go through the analysis, people on Medicare—it appears that by 1990, senior citizens on Medicare, under the cuts that you are proposing here, will have to spend out of their Social Security income another $470 a year, to maintain the medical protection that they have today.

That is how severe the cuts are in Medicare, that is in that document today. Second, the UDAG Program which has been one of the most effective programs in this country in terms of promoting private investment in areas that are in difficulty across the country, is proposed to be eliminated altogether.

There are enormous cuts in education and in student loans. We heard the President talk about last night preparing for the future. The way we prepare for the future is by investing in education. Here is Japan producing twice the number of engineers per capita, each year, as the United States, and you are in here today proposing major cutbacks in education; major cutbacks in job training assistance.

You are proposing, for the first time, to means test, health care for veterans of this country who went off to serve in various wars and various conflicts, presumably with a promise that one of the things they would receive in return from their country was health care, and you are very substantially restricting access to that health care to that veterans group.

You are cutting back sharply on health research in cancer. We have got an AIDS problem in this country of a dimension that we do not even understand yet, and a host of other diseases. All those areas are being cut.

We have got a crisis in American agriculture. You are proposing major cuts, several billion dollars of cuts this year over what was spent last year, which, by itself, seemed to be insufficient to really help very much with the farm problem.

TRADE IMBALANCE

And finally, as Senator Sasser has pointed out, there is absolutely nothing in here to correct the trade disaster. You have no strategy. Zero strategy and nothing to back it up. We have just become a debtor nation for the first time since 1914. The New York Fed says we are going to owe the rest of the world somewhere between $500 billion and $1 trillion by 1990, and we have got all these hundreds of billions of dollars and millions of jobs flowing out of the country.

And you come in here with a budget today, after 5 years of an administration, and no plan, nothing to deal with that problem.

I just think that is unacceptable and I think when the public understands what is in here, they are going to ask you to revise it and hopefully it will be very substantially revised.

Chairman DOMENICI. Thank you very much, Senator. Senator Gorton.

OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. Thank you, Mr. Chairman.

For more than a decade, the economy of the United States has been reaching economic crossroads. One direction has led to disaster, the other direction has led to a long, slow recovery.

In 1980 that imminent disaster was inflation. We made the effort to turn away from that disaster and with the cooperation of the President and Congress, have met that challenge.

In 1982, it was that terribly, terribly unacceptable high rate of unemployment. We made the effort to turn away from that and made great progress in meeting that challenge. In 1984, it was interest rates which were so high that they were choking off economic growth in the United States. We have gone a long way toward meeting that challenge.

Last year, and this year, our imminent challenge has been conquering a huge and seemingly uncontrolled Federal deficit. Last year members of this committee made a number of constructive proposals which would have met that challenge in the same way that we met the others, but those proposals were rejected for one reason or another.

DEFICIT REDUCTION NO LONGER AN OPTION

Gramm-Rudman, in my opinion, was the inevitable result of that failure—a demand that we discipline ourselves. The result is that deficit reduction is no longer an option. It is not one of the things that we are going to talk about. We are going to meet that $144 billion goal one way or the other.

It seems to me that this year we have three options in meeting that goal. First, is the mindless, across-the-board reductions which will take place automatically because of Gramm-Rudman without any sense of priority or national need at all. Second, is the attempt, represented by this budget document. It would effectively cram an unbalanced proposal of cuts in vital and important domestic areas, down the throats of the Congress and the American people, while using every dollar or more than every dollar of increased revenues resulting from the natural growth in the economy for one and one field only—for the Pentagon. Third, is the way that has been so eloquently outlined by the chairman, the ranking minority member, and by several others which recognizes that we have to reach an accommodation.

REDUCTIONS IN SPENDING GROWTH RATE

I believe that most of that accommodation, the great share of that accommodation, will come from reductions in the growth rate of Federal spending. It will be in defense as well as nondefense and if it is evenly done it will not mean huge cuts in many important domestic spending programs, but rather, a smaller rate of increase. And it probably, from a political standpoint is going to require some increases in revenue as the chairman and the ranking minority have laid out.

Now, I recognize that you are here, your paycheck, in effect, is signed by the President of the United States and you are here as his messenger. You are doing a good job of bringing his message to us.

But if you are to go down as hero, as someone who really helped to solve this problem, you need to be a double messenger. You need to be a messenger from this committee and other Members of the Congress and of the people of the United States back to the President in saying that this kind of accommodation is necessary if we are to meet this challenge.

Chairman DOMENICI. Thank you very much, Senator.

Senator Metzenbaum.

Senator METZENBAUM. I think Senator Moynihan was first.

Chairman DOMENICI. Senator Moynihan.

OPENING STATEMENT OF SENATOR MOYNIHAN

Senator MOYNIHAN. Mr. Chairman, on the general subject of the prospects of this document, I cannot, nor can my colleagues from this side, fail to see those great empty spaces on the other side. We would suggest that there has not been the great enthusiasm that we hoped would accompany the President's budget submission. But that is another matter.

I just wanted to make two points, Dr. Miller. In welcoming you again, I hope that you would address the following points either in your remarks or in your comment.

Two weeks ago, when you were here, sir, we asked about the estimates for the deficit in fiscal year 1987 and we were told that it would be $200 billion plus or minus. And in the document we have today, it has come down all of a sudden to $182 billion. Now, you obviously have had some reasons for doing that.

The other surprise is that in the course of the next 5 years, we are going to add enough new debt, regardless that we will approach the $3 trillion level in total national debt. It was the second trillion that caused the trauma of Gramm-Rudman I suppose, and yet, we see that debt service is projected to drop. And it drops from $142 billion in this year, to $129 billion 5 years hence. I hope we can learn more about why you think that will happen.

Thank you.

Chairman DOMENICI. Thank you very much.

Senator Metzenbaum.

OPENING STATEMENT OF SENATOR METZENBAUM

Senator METZENBAUM. Mr. Chairman, last evening we heard the President of the United States and I think there was a certain glow, a certain vision of hope. But today we hear from Mr. Miller, and he brings nothing with him but a budget full of dark clouds.

He brings us a budget that spends $1 trillion on defense over the next 3 years, that means $13,000 for every household in America. He brings us a budget that cuts over $100 billion from human service programs, over the same period.

It is very difficult for Americans to understand a budget that spends more on military bands than it does on urban development grants for our cities.

It is a budget which spends more on increased subsidies for a single Arizona water project, than it does on legal services for the poor. It is a budget which spends more on interest payments to foreigners, than it does on educating American kids.

PRESIDENT SQUIRMS

The President has said that he squirms a little when they call it the President's budget. And I think I understand why. And I think the over 400,000 to 560,000 unemployed workers in Ohio would understand a sense of disappointment in that budget, and I think the farmers who are losing their homes at an unbelievable pace in Ohio would understand why the President squirms with respect to his budget.

And the sad part is that we hear this talk of bipartisanship and I respect the President and his call for bipartisanship and we always hear that when things are going rough. But I think that David Stockman stated it well when he said,

> After 4 years, I am convinced that a large share of the problem is us.
>
> By that, I mean Republicans in Congress.
>
> These guys get away with making these speeches about how spending is out of control, but when it comes to their own piece of turf, they say, do not cut you, do not cut me, cut the other fellow behind the tree.

Of course, one could add, says Stockman, what is new about that?

WESTERN GRAZING FEES

And in that connection, I think we have had no better evidence than the February 2 edition of the Washington Post, which talks about Western grazing fees slipping out of the budget noose. They are supposed to go up—the present rate is $1.35 and they are supposed to go up to $6.87 and what happens? Eighteen U.S. Senators on the Republican side, including the total leadership, including the leadership of this committee, writes to you and urges that that matter be postponed. I do not know how big an item it is. I do not know how much money is involved. But I have to say to you, Mr. Miller, that it is really disappointing to see that you immediately accepted the letter and then sent a memo to Reagan recommending retention of the $1.35 per month grazing fee, until March 1987. I think that any fair and objective observer would say, you made a political call, that was a political decision. It was not the right decision and it is disappointing.

Chairman DOMENICI. Thank you very much, Senator.

Mr. Miller, I figured that once the speeches started that I ought to let you hear them all. I thought I would give you a little idea of what we go through up here.

Incidentally, that formula on grazing that he is referring to, if it was extended under its present base, instead of $6, it would be $1.07. It would go down instead of up. That is the formula Congress passed based on the economics out there in the field. So we have to listen to it all and I am sure that we could balance the budget on that $12 million that you might get if you raised it to $3, $4, or $5. And then payed unemployment to the ranchers who went broke and then we could give a speech about them, how bad off they were.

Dr. MILLER. Also, the letter was to the President, not to me, and I am sure that the 18 Senators were quite unhappy that I recommended freezing the fee rather than letting it fall.

Senator **Lautenberg**. We will take a freeze in a lot of these programs.

Chairman **Domenici**. We will. We will get some freezes.

We will get a lot of them.

In any event, I want to say to the distinguished Senator from Ohio, we all share some of the blame, but if he looks our way, in terms of voting for budget cuts, we have done that a couple of times. That does not mean that all of us, that our President went with us, but we did take some pretty good medicine and we voted for a lot of them. On a lot of them he took the opportunity to go down and share with the whole world how terrible we were for freezing things like Social Security and the like but we tried all of those. This year, we hope to do better with his help. We really hope for that.

Now, Senator Lautenberg, you may proceed.

OPENING STATEMENT OF SENATOR LAUTENBERG

Senator **Lautenberg**. Mr. Chairman, if I may, I would like make some brief remarks. Mr. Miller, we have your budget documents. I agree that you have worked hard. I think that you chose a poor color for the books. They are in blue covers this year, but red would be a more appropriate color, I think, for the delivery of this news. Then people would know that we have a serious problem. But what has been cooked up is a plate of left-over proposals, I think, some spice by the way of new ideas, but not a serious attempt to work with Congress on an acceptable budget, despite public pleas to the contrary.

HOW NOT TO BALANCE THE BUDGET

People in my State think that the deficits are a problem and they want us to solve it. But they do not want to do it at the expense of educating our children, or providing medicl care to the elderly, or at the expense of avoiding toxic waste clean-up, or cutting back on roads and rails that in a crowded State like mine, are essential in a growing economy.

And they do not want to pour out an additional $36 million to the Pentagon and watch hundreds of millions of it leak out the windows or under the door.

Now, we are told that we do not have many choices, because Gramm-Rudman is here, but it is a bit ironic to me, I have got to tell you, to hear those who supported Gramm-Rudman-Hollings, say now, they really do not want it to work.

UNCOLLECTED TAXES

It reminds me of the kind of statement made by defendants who walked into the store with a loaded gun and said they never planned to use it, but it accidentally went off. So, I think we ought to stop kidding ourselves about where we are going. Before we cut the fiber, the muscle, out of some of these programs I think we have to take a look at some revenues and not new taxes, but old taxes that go uncollected. We can improve the revenue stream.

Mr. Miller, I hope that in the course of this hearing we will have a chance to discuss my ideas about tax amnesty and related issues.

Thank you, Mr. Chairman.

Chairman **Domenici**. Thank you very much.

Senator Exon, I did not know that you wanted to be heard and I apologize.

OPENING STATEMENT OF SENATOR EXON

Senator **Exon**. I will be very brief.

I welcome you here and I wish that we could understand that we are not here to kill you, you are the messenger. I think that you have merely carried out as best you could working for the President, the mandates of a Congress under Gramm-Rudman.

You know, it is here now. It seems to me, Dr. Miller, that while I would agree and will disagree, I will agree that you tried very hard, I will disagree with the way that you have made these allocations, but to a large extent, you are going to come back and say, they had to come from somewhere.

It seems to me that what many who supported Gramm-Rudman are now hoping and praying for as the only deliverance—rather than repenting—would be a court decision that this whole mess cannot go forward. With regard to the unfairness of the situation and how ill-advised it is, after passing a hard fought agriculture bill that I thought was far short of what it should have been, I see now, for example, that for 1986 and 1987, as I had anticipated, agriculture is cut by 24.4 percent for those first 2 years, while national defense goes up over 8 percent above inflation and international affairs 8 percent.

Those kinds of figures are going to be extremely difficult to sell in hard pressed Nebraska these days. There are going to have to be some changes but I do not hold you accountable for them, Dr. Miller.

Thank you.

Chairman **Domenici**. Thank you very much.

We have received a statement from Senator Hatch, who is unable to be here today, and it will be included in the record at this point.

[The statement of Senator Hatch follows:]

Statement of Senator Hatch

The President should be commended for submitting a budget which among many of its worthy budget goals, adheres to the maximum deficit-reduction target of $144 billion for fiscal year 1987 prescribed by the Gramm-Rudman-Hollings law enacted last year; preserves Social Security benefits; maintains necessary spending levels for America's fundamental commitment to national security; and reiterates the President's long-term resolve to NO TAX INCREASES.

I applaud the President for his resolve not to increase taxes, and I wholeheartedly agree with the President that it is the spending side of the equation, not the revenue side, which fuels annual deficits now regularly exceeding $200 billion.

EVERY WAISTLINE MUST FEEL THE PINCH

Recognizing that the automatic sequester mechanism of Gramm-Rudman-Hollings will pinch the budget waistline of every American, I believe GRH should be given a fair chance; spending reduction is possible and a balanced budget obtainable. I do not say it will be an easy chore, and everyone, from Senators, bureaucrats, to constituents must share in the sacrifices necessary to obtain our goal of a balanced budget by 1991. Just in the Senate Labor and Human Resources Committee which I chair, savings of $1 billion, or in real terms a reduction of 25 percent, have been incurred in the cost of programs under this committee's jurisdiction from fiscal year

1980–fiscal year 1985. These savings were achieved by more efficient and better management of social service programs. If savings of this size had been enacted by each Senate and House committee, we would enjoy a $150 billion budget SURPLUS instead of a $212 billion deficit realized in fiscal year 1985, assuming current tax laws and policies.

SPENDING STEADILY INCREASING

The red ink of budgets past will continue if Congress' spending record is any indicator of years of fruitless attempts to reduce the deficit. As I review the weekly scorekeeping report found in the Congressional Record, my conclusion that excessive spending, not reduced revenues is the cause of the current deficit dilemma, is supported by the bare numbers. Thus far, five months into fiscal 1986, outlays exceed by $19 billion the assumed level of outlays found in the First Concurrent Budget Resolution for fiscal year 1986. Four of the five past fiscal years have shown actual outlays to exceed congressionally approved outlay targets found in the First Concurrent Budget Resolutions. The whims of Congress, fostering unchecked spending, must be contained if we here in Congress are truly committed to deficit reduction.

In summary, Congress must exercise its will to control deficit spending, and I think the President's budget is a good guide to the tedious and difficult task to restore fiscal responsibility to the budget and achieve a spending balance between defense and domestic programs.

Senator **Domenici**. Now, Mr. Director, we look forward to your testimony. If you have prepared remarks we will make those prepared remarks a part of the record and you are free to excerpt them and use them as you see fit, and use whatever charts you may have.

We will try not to interrupt your remarks for a while in any event, and then we will question you.

Please proceed.

STATEMENT OF HON. JAMES C. MILLER III, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Dr. **Miller**. Thank you, Mr. Chairman and members of the committee. It is a pleasure to appear before you today, to present the President's budget for fiscal year 1987.

ECONOMIC EXPANSION GREATEST IN 35 YEARS

It is even more of a pleasure because of the economic expansion the country is now enjoying—one of the most vigorous in 35 years. Family income is at an all time high, production and productivity are increasing; employment gains have been extraordinary; inflation which ranged in the double digits just 5 years ago, has been reduced dramatically.

During the past 3 years, real GNP has grown at more than double the annual rate of the past 3 years of the previous administration. The prime rate of interest and other key interest rates are less than half what they were 5 years ago. Also, during the past 3 years, corporate profits have increased 117 percent and stocks have nearly doubled in value.

I could go on and cite more statistics like that, but the point is that the economic recovery that began in 1982, is now in its fourth year and provided that we are responsible in our actions, will not be attenuated. Now, this dramatic growth is due to the kinds of programs that the President announced in February 1981—tax cuts, budget restraint, regulatory relief, and a stable monetary policy.

But the one major point that has not been dealt with, as Senator Gorton pointed out, is the deficit. And it seems to me that we must, in fact, do something about getting the deficit under control.

This budget does that and it meets the requirements of the Gramm-Rudman-Hollings Act, of a balanced budget by 1991 and a $144 billion maximum deficit for fiscal year 1987.

POSSIBLE TO ELIMINATE DEFICIT WITHOUT TAX INCREASE

The budget shows, moreover, that eliminating the deficit is possible without increasing taxes, without cutting into the 3-percent real growth in defense that the President agreed to in the CBR last August, and without cutting into vital programs for the poor and the elderly.

I believe a tax increase would jeopardize our economic expansion. There is no need to break faith with the poor and the elderly and a defense cut, I think, would be the wrong thing at a time when we finally have the Russians at the bargaining table, and it would also create uncertainty with our allies.

Now, the President's budget proposes outlays for 1987 of $994 billion and receipts of $850.4 billion. We hold to the Gramm-Rudman-Hollings targets. On a current service basis, outlays are estimated to be $1,025.9 billion and receipts at $844.1 billion, thus resulting in a deficit of approximately $182 billion and I would like, at some point, to respond to Senator Moynihan's question about that issue.

[The following was subsequently submitted for the record by OMB:]

CURRENT SERVICES DEFICIT PROJECTION

In January, our projection of the current services deficit in 1987 was $194 billion, $50 billion above the Gramm-Rudman-Hollings target. The current services deficit for 1987 shown in the February budget is $182 billion, $12 billion below the January estimate. Two factors account for most of this decrease:

The January estimates did not reflect the impact of the FY 1986 sequestration. The February current services estimate for nondefense were done on a post-sequestration basis and are almost 7½ billion below our earlier estimates.

The earlier baseline included outlays of $4.4 billion for general revenue sharing (GRS). Since the Congress has indicated that it does not plan to renew GRS, we decided to drop general revenue sharing from the current services estimate. The February current services outlay estimates for 1987 include only $0.8 billion for GRS, which reflects the final payment for FY 1986.

In order to achieve the 1987 target, the deficit must be reduced by $38 billion for fiscal 1987. The President's budget proposes 1987 deficit reductions of $38.2 billion. Of that, $6.3 billion comes from higher Government revenues. This is, receipts as the result of employee contributions to Federal retirement funds; initiatives by the IRS to collect more taxes already owed and accepting the all but inevitable extension of the extra 8 cents per pack tax on cigarettes.

An additional $3.2 billion comes from selling various real and financial assets; increased user fees account for $2.4 billion, and the overall reduction in the deficit will save some $1.2 billion in interest expense.

This leaves $25.1 billion which is derived from programmatic reductions. Since $2.7 billion of this amount comes from reductions in defense funding, while still meeting the President's goal of a 3-percent real increase only $22.4 billion of the $38.2 billion, which is less than 60 percent, must be obtained from cuts in non-defense areas.

The President's budget proposes to achieve these deficit reductions by ending Federal activities that have outlived their usefulness; by transferring to State and local governments or the private sector activities that they could operate more efficiently; by eliminating Government competition with the private sector; by making appropriate changes in the scope of remaining programs, including better targeting of social service programs; and by making the remaining Government programs work more efficiently, more effectively and by making them more accountable.

ELIMINATE OUTDATED PROGRAMS

Let me give you a couple of ideas of what kinds of changes we are proposing for those programs that have outlived their usefulness or were inappropriate from the very beginning. We plan to eliminate the Small Business Administration Credit Programs; the Amtrak subsidy, UDAG grants; Appalachian Regional Commission; Economic Development Administration and the Interstate Commerce Commission. Also we propose to eliminate education subsidies for the health professions, the Work Incentives Program, and air carrier subsidies.

Functions that properly ought to be operated at State levels include economic development assistance, the non-farm part of the agricultural extension service. Also, the Federal Government should get out of the business of paying for local sewage treatment systems; local law enforcement; subsidies to local mass transit; State maritime schools; and local coastal management. Commercial-type operations where it would be better for the Government to get out of the business and stop competing with the private sector, lead us to propose the sale of the power marketing administrations, and the Naval Petroleum Reserves.

This budget also proposes the sale of unneeded assets, such as loan portfolios and surplus real estate, and contracting out appropriate Federal services.

The budget proposes reforms to limit the cost and improve the targeting of Federal programs that have become overextended and misdirected or operate on too expansive a scale, such as Medicare, Medicaid, subsidized housing, civil service pensions, health benefits, Postal subsidies, interstate highway grants, and the Forest Service.

Finally, those who receive special benefits and services from the Federal Government should be the ones to bear the cost for these services, not the general taxpayer. Accordingly, the budget imposes fees and premiums for Federal guarantees of loans and imposes user fees and charges for Federal cost recovery of meat and poultry inspection, national park and forest facilities, harbor and inland waterway use, Coast Guard and Customs inspections and for many other services.

The budget envisions a number of changes and improvements pursuant to our emphasis on management. Today the President signed the second management report to Congress, the first one that he has signed. This is a reflection of the fact that at OMB we are giving much higher emphasis to the management sector, and in fact, a number of the reductions will come about because of increased management efficiency.

EXPANDS HIGH PRIORITY PROGRAMS

Despite the tight fiscal environment, the budget provides funds for maintaining and, in some cases, expanding high priority programs in crucial areas of national interest. Necessary services and income support for the dependent poor and elderly receive significant funding in this budget, and so do other programs of national interest, including: Drug Enforcement, AIDS Research, the Space Program, Nonmilitary Research, and National Security.

And while national security continues to be one of the President's highest priorities, national defense has not been exempt from general budget scrutiny. Last summer the President agreed reluctantly with Congress to scale back planned growth in defense appropriations to a zero level. As you know, under Gramm-Rudman-Hollings there will be 1986 sequestration reducing defense budget authority below the preceding year in real terms. This budget would return the Defense Department to a steadily rising well managed funding of defense.

So, in summary, the President's budget provides adequate funding for vital programs for the poor and elderly and for our Nation's defense and for other high-priority items and meets the Gramm-Rudman targets of $144 billion for fiscal year 1987 down to a balanced budget in 1991.

UNDERSTAND DIFFICULTY IN MAKING CUTS

Now, I recognize, Mr. Chairman and members of the committee, how difficult it will be to make some of the cuts I have outlined today, and that are detailed in the budget documents. Strong special interest groups exist to lobby for almost every Government program, no matter how inefficient, how outdated or how irrelevant to the average taxpayer. Nevertheless, if we take our medicine now, we will make the $25 billion cuts in programs for fiscal year 1987, and by doing so, we avoid both the 1987 sequester and additional cuts in later years to meet the Gramm-Rudman-Hollings schedule of deficit reductions.

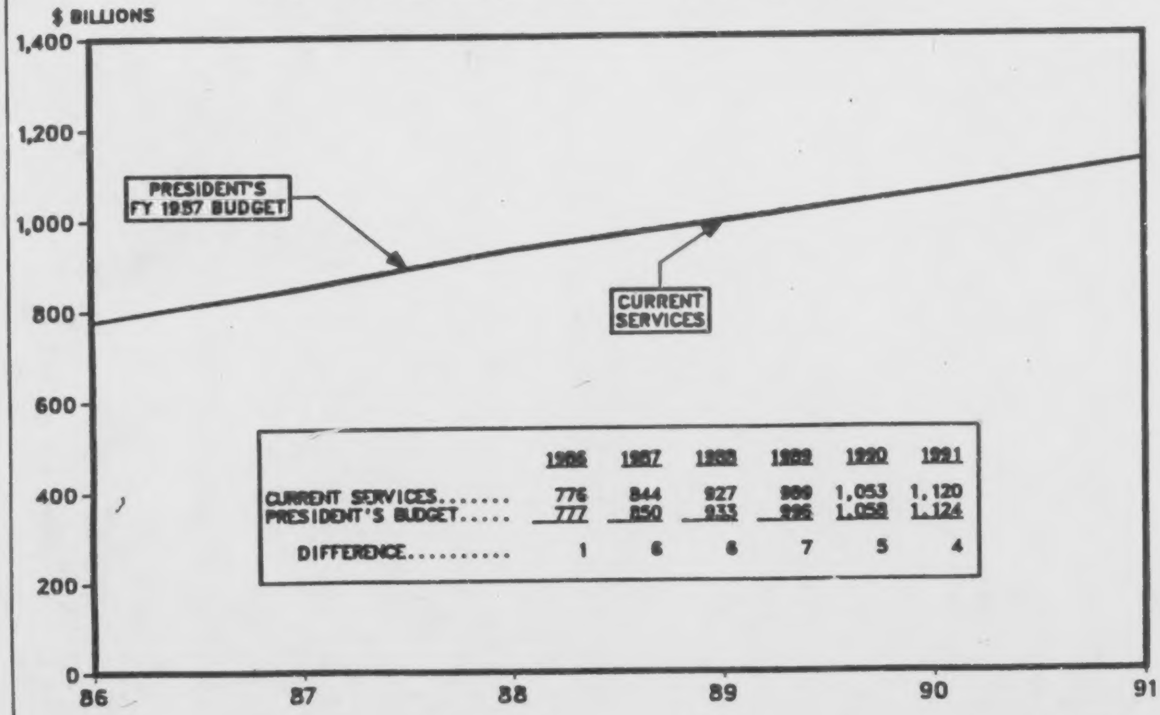
The President's budget through a combination of increased revenues, program terminations, many of them long overdue, and spending cuts and other reforms, meets the $144 billion target for 1987. Any alternative approach would attack the family budget by increasing taxes, would deteriorate our national security posture, or would break faith with the poor and the elderly.

The President's approach, I would submit, is in the long-term interest of the American people. Accordingly, I urge that you give it your prompt and favorable response.

Now, Mr. Chairman, with your permission, I would like to go to a set of charts, if I might, and explain functionally what we propose for this budget.

The present budget decreases the deficit by $38 billion in fiscal year 1987, and complies with the Gramm-Rudman-Hollings targets all the way through 1991. It avoids increases in the tax burden, supports the bipartisan consensus not to cut Social Security, funds national defense at compromise levels and protects low-income support and benefits for the needy.

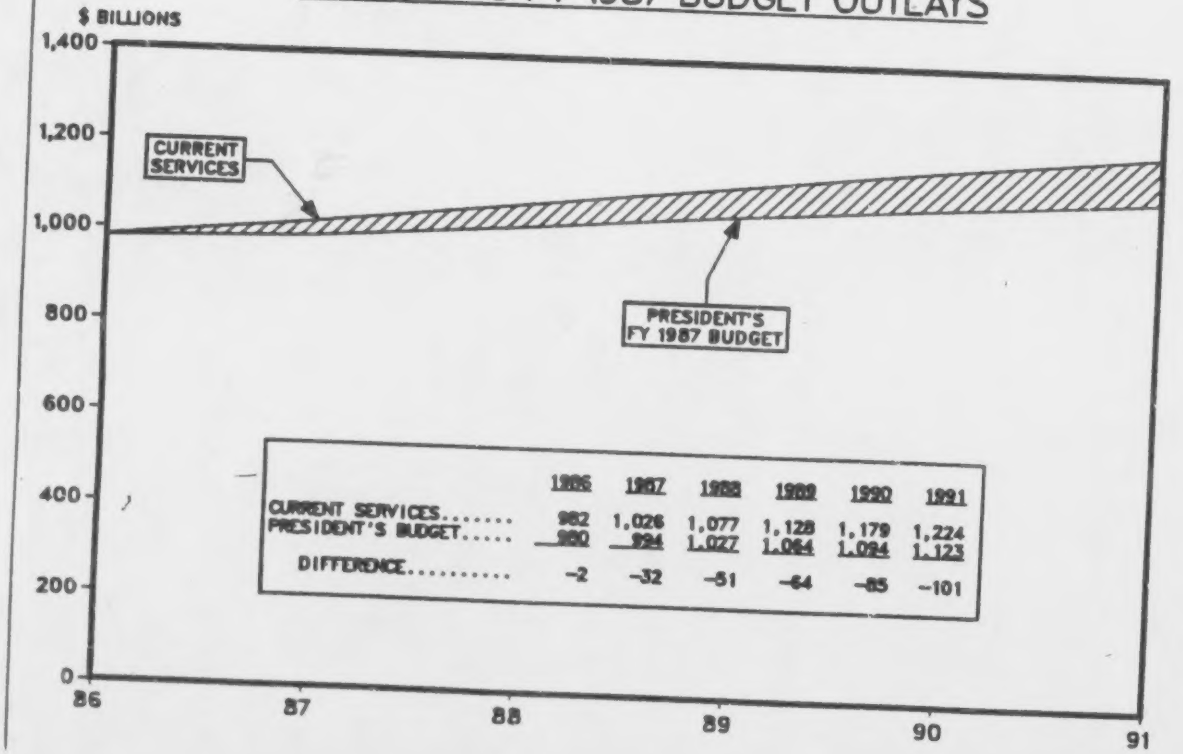
PRESIDENT'S FY 1987 BUDGET RECEIPTS



	1986	1987	1988	1989	1990	1991
CURRENT SERVICES........	776	844	927	989	1,053	1,120
PRESIDENT'S BUDGET.....	777	850	933	996	1,058	1,124
DIFFERENCE...........	1	6	6	7	5	4

This chart shows a time series for revenues under current services, compared with revenues under the President's budget. As you can see, there is a slight difference between the two. The higher line reflects the revenues that the Government would receive under the President's budget—a $6.3 billion increase above current services in 1987. This increase reflects IRS's more efficient collection of the taxes already due; the acceptance of the all but inevitable extension of the extra 8 cents per pack tax on cigarettes and several other items that I could get into in detail, if you would like, explain this slightly higher revenue figure. As you can see it is $6 billion in 1987 and it is approximately that for each year through 1991.

PRESIDENT'S FY 1987 BUDGET OUTLAYS

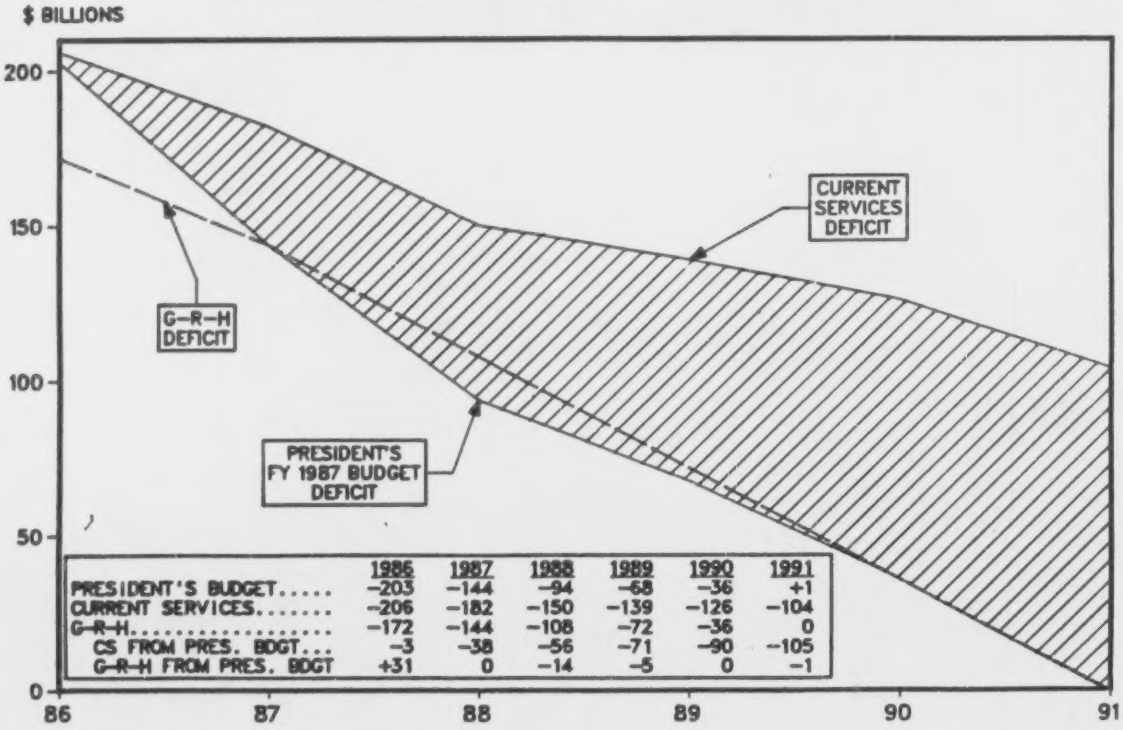


	1986	1987	1988	1989	1990	1991
CURRENT SERVICES........	982	1,026	1,077	1,128	1,179	1,224
PRESIDENT'S BUDGET......	980	994	1,027	1,064	1,094	1,123
DIFFERENCE...........	-2	-32	-51	-64	-85	-101

This chart compares the current services outlays for the fiscal years 1986 through 1991, with the outlays contained in the President's budget.

As you can see, there is a savings of $32 billion from lower outlays in fiscal year 1987. Of course, the 32 plus the 6.3 in increased revenue, explain the $38 billion savings that we have to have in order to reach a $144 billion deficit, the level required for fiscal year 1987.

PRESIDENT'S FY 1987 BUDGET DEFICIT PATH



	1986	1987	1988	1989	1990	1991
PRESIDENT'S BUDGET.....	−203	−144	−94	−68	−36	+1
CURRENT SERVICES.......	−206	−182	−150	−139	−126	−104
G-R-H..................	−172	−144	−108	−72	−36	0
CS FROM PRES. BDGT...	−3	−38	−56	−71	−90	−105
G-R-H FROM PRES. BDGT	+31	0	−14	−5	0	−1

This perhaps is the most interesting chart, for it shows the deficit path, under current services. If we make no policy changes, the deficit will fall from $205.6 billion as estimated by OMB and follow the path here, ending in fiscal year 1991, with an approximately $104 billion deficit. Obviously, this current services line has to be pushed down somewhat in order to meet the Gramm-Rudman-Hollings targets. As you know, the targets are $172 billion for fiscal year 1986 falling to zero for 1991.

Now, the lower line is the President's 1987 budget. For 1986, there are a few recissions, which would lower outlays in 1986 and the outyears. The additional reductions for 1987 would lower outlays in that year and drive down the level of expenditure through all of the years.

A very important point that I want to make is that as portions of the President's budget began to leak out, there was a feeling that a lot of cuts were coming and a lot of terrible, terrible things were going to happen and this was just the first year of such terrible, terrible things happening.

The fact of the matter is, as I guess it was Senator Boschwitz who pointed out, that if we make these policy changes this year, in fact, the President's budget will force down the baseline of spending to meet the Gramm-Rudman-Hollings targets through all of the out years. So, the policy changes contained in the President's budget, assuming again, that our economic assumptions hold, will result in our meeting the Gramm-Rudman-Hollings targets throughout this 5-year period and will result in a balanced budget by fiscal year 1991.

Chairman DOMENICI. Does your definition of current services on the top line include your understanding of defense for 1987?

That is, 3 percent as the President understood it last year——

Dr. MILLER. Yes.

Chairman DOMENICI. It does?

Dr. MILLER. Yes.

Chairman DOMENICI. In all other respects, his current services use the appropriated account levels post-sequester and add inflation to them?

Dr. MILLER. Yes, it does.

Chairman DOMENICI. So that is the only place where you differ from that formula?

Dr. MILLER. That is correct.

FY 1987 BUDGET TOTALS
(in billions of dollars)

	FY 86	FY 87	FY 88	FY 89	FY 90	FY 91
President's Budget						
Receipts	777.1	850.4	933.2	996.1	1058.1	1124.0
Outlays	979.9	994.0	1026.8	1063.6	1093.8	1122.7
Deficit	−202.8	−143.6	−93.6	−67.5	−35.8	+1.3
Gramm-Rudman-Hollings Targets	−171.9	−144.0	−108.0	−72.0	−36.0	0.0
Deficit Reduction From Current Services Baseline	2.8	38.2	56.4	71.4	90.5	105.2
Increased Receipts	0.7	6.3	5.9	6.9	5.0	3.8
Outlay Reductions	2.1	31.9	50.5	64.5	85.5	101.4

This chart indicates the effects of the President's budget. The deficit would be $202 billion for 1986; $143.6 billion for 1987, and reach an actual surplus of $1.3 billion in fiscal year 1991. As you can see, for 1987 through 1991 the budget meets the Gramm-Rudman-Hollings targets.

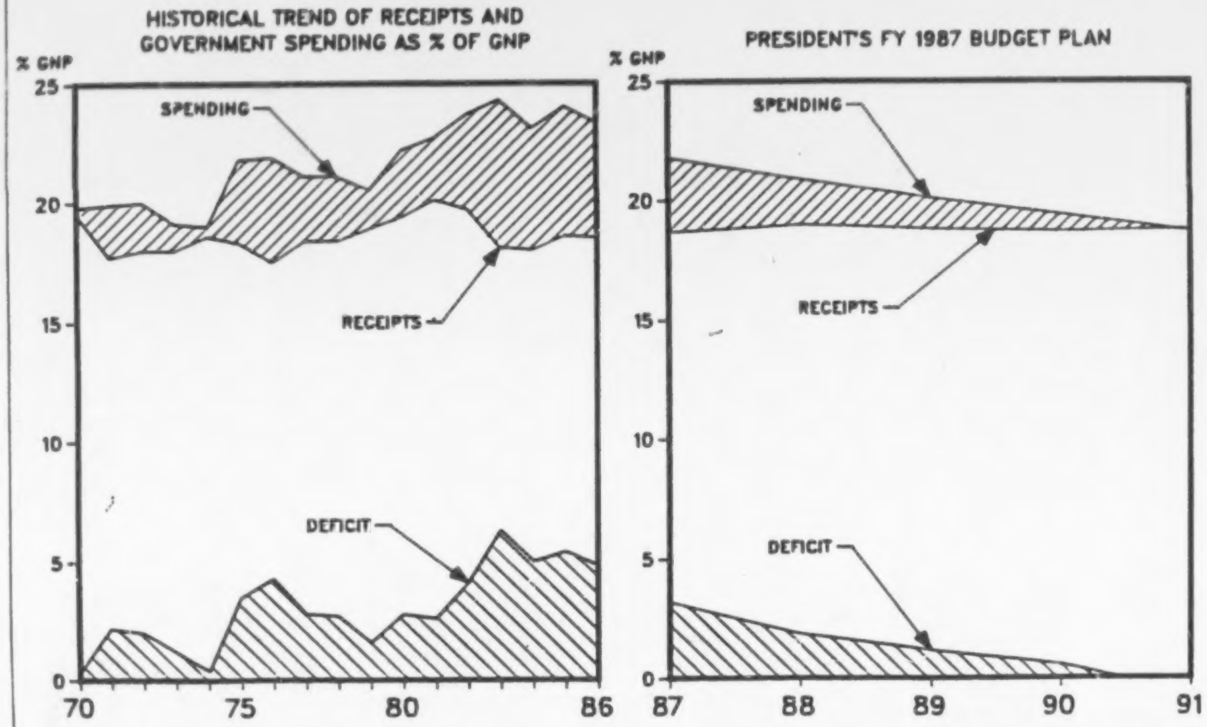
These are the changes from the current services baseline and they show that for 1987, for example, we propose a $6.3 billion increase in revenues and a $31.9 billion reduction in outlays.

Now, before I get into the details, I would just like to make a few points, if I might?

SPENDING INCREASED AS PERCENT OF GNP

The first point is that I do not think that increasing taxes is the answer.

TAX INCREASE IS NOT THE ANSWER: GOVERNMENT SPENDING IS THE PROBLEM



HISTORICAL TREND OF RECEIPTS AND GOVERNMENT SPENDING AS % OF GNP

PRESIDENT'S FY 1987 BUDGET PLAN

As you can see here from a time series of receipts as a proportion of gross national product from 1970 to 1986, receipts have remained rather constant—they varied around a mean of approximately 18 or 19 percent of the gross national product. On the other hand, spending, as you can see, has risen fairly dramatically over this period of time, as a proportion of gross national product. And the deficit, while it has bounced around, has grown fairly large here, again as a proportion of the gross national product.

Now, under the President's budget, the receipts will stay rather stable over the period 1987 through 1991 at approximately 18 or 19 percent of the gross national product, however, spending will fall and so will the deficit over this period. A balanced budget will be reached by fiscal year 1991.

Chairman DOMENICI. Now, that includes Social Security receipts and Social Security spending?

Dr. MILLER. Yes.

Chairman DOMENICI. I have one other question, just quickly, as I move through here, do you have the entire expenditures of Government, as you have it graphed there, do you have it broken down into entitlements and nonentitlements?

Dr. MILLER. I do not, but I can provide that if you like.

Chairman DOMENICI. Is it true, however, that the growth is substantially more in the entitlements than it is in the nonentitlements?

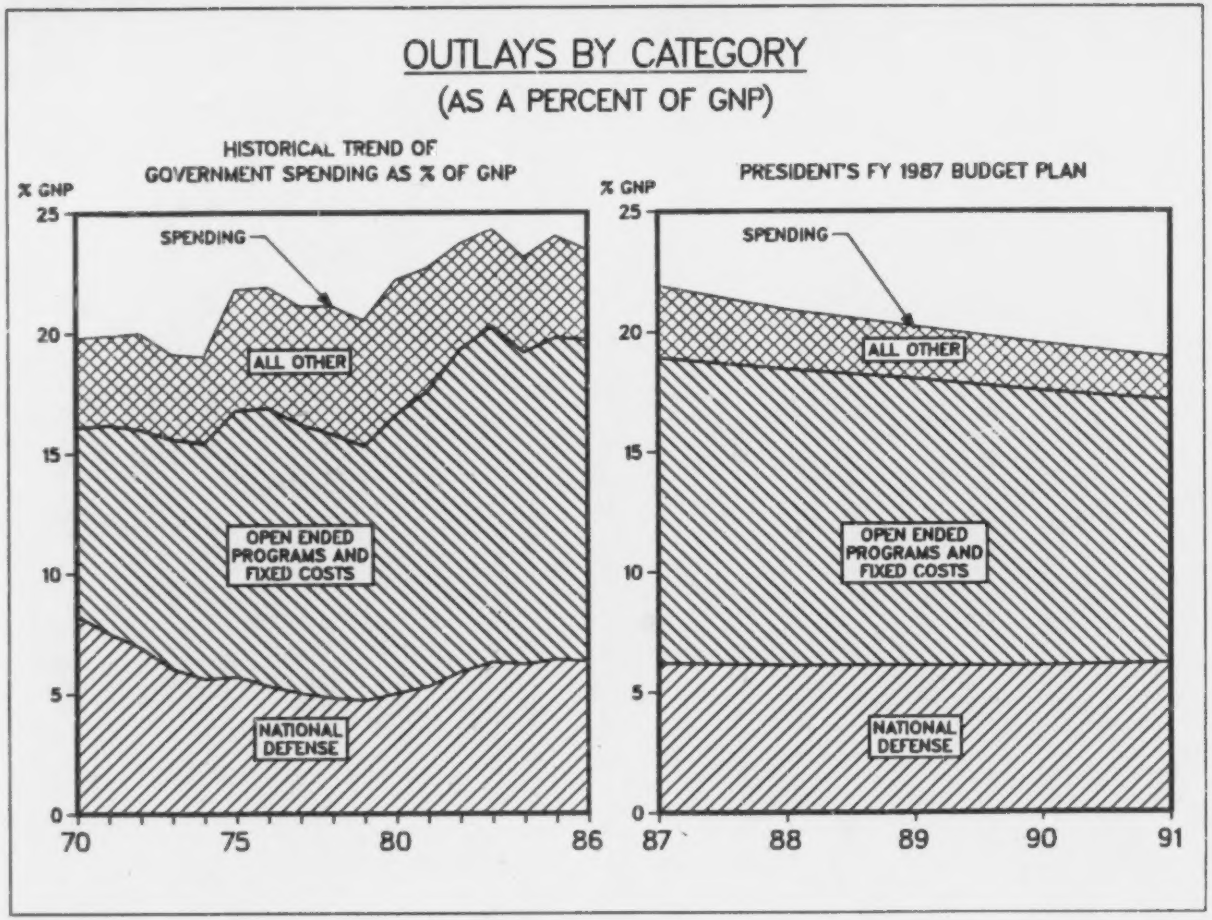
Dr. MILLER. Yes, it is, that is correct.

Chairman DOMENICI. I wonder if you could do that for us and also separate defense over the same timeframe and present that to the committee in a similar form?

Dr. MILLER. I would be glad to do that.

Chairman DOMENICI. I would appreciate it.

[The following was subsequently supplied for the record by OMB:]



OUTLAYS BY CATEGORY

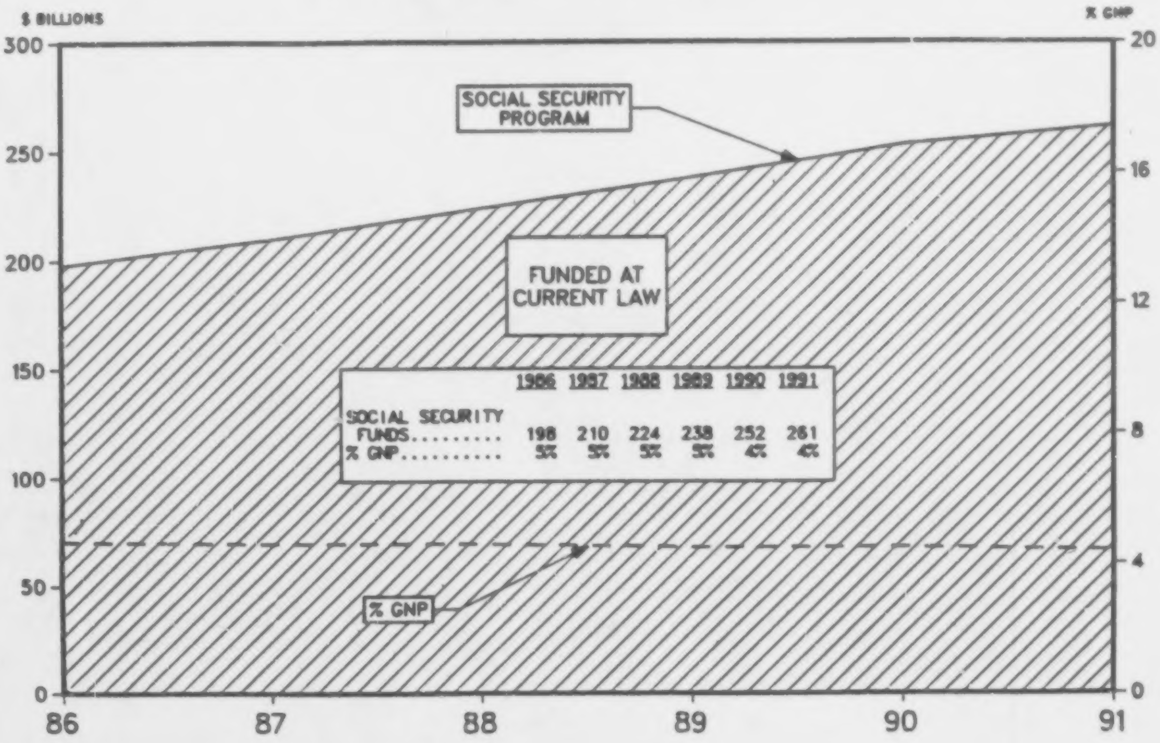
(AS A PERCENT OF GNP)

BACK-UP DATA FOR CHART:
OUTLAYS BY CATEGORY
As a % of GNP

	National Defense	Open Ended Programs & Fixed Costs	All Other	Total
1970	8.2	7.9	3.7	19.8
1971	7.5	8.7	3.7	19.9
1972	6.9	9.1	4.0	20.0
1973	6.0	9.6	3.5	19.1
1974	5.6	9.8	3.6	19.0
1975	5.7	11.1	5.0	21.8
1976	5.3	11.6	5.0	21.9
1977	5.0	11.2	4.9	21.1
1978	4.8	11.0	5.3	21.1
1979	4.7	10.6	5.2	20.5
1980	5.0	11.6	5.6	22.2
1981	5.3	12.3	5.1	22.7
1982	5.9	13.4	4.4	23.7
1983	6.3	14.0	4.0	24.3
1984	6.2	13.0	3.9	23.1
1985	6.4	13.4	4.2	24.0
1986	6.3	13.4	3.7	23.4
1987	6.2	12.7	3.0	21.9
1988	6.1	12.3	2.5	20.9
1989	6.1	11.9	2.2	20.2
1990	6.1	11.4	2.0	19.5
1991	6.2	10.9	1.8	18.9

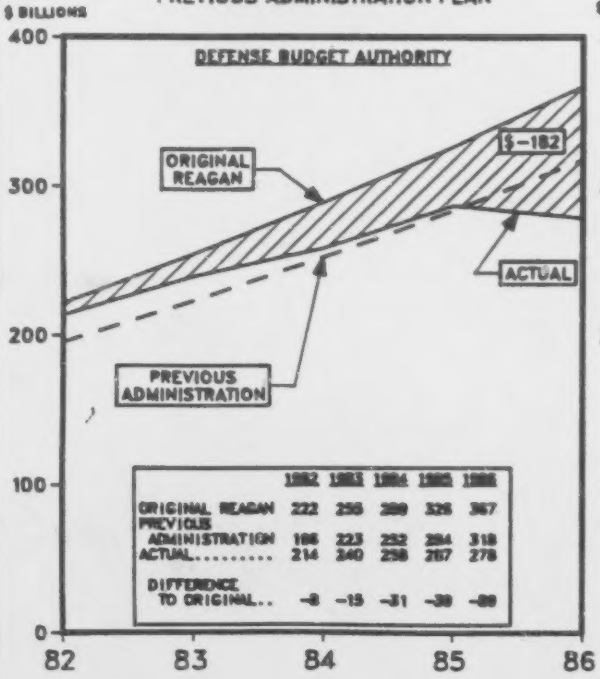
Dr. MILLER. I do not believe that cutting Social Security is the answer. Under current services, Social Security outlays will rise, but as a proportion of gross national product, will remain rather stable through this period of 1986 through 1991. In fact, it will fall a slight amount.

SOCIAL SECURITY PROGRAMS PROTECTED: BIPARTISAN CONSENSUS OBSERVED



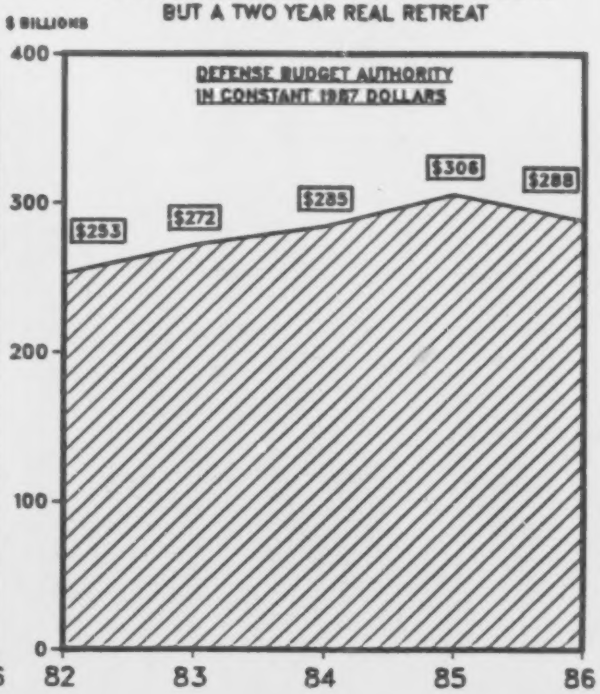
	1986	1987	1988	1989	1990	1991
SOCIAL SECURITY FUNDS..........	198	210	224	238	252	261
% GNP..........	5%	5%	5%	5%	4%	4%

DEFENSE PROGRAM HAS BEEN CUT:
MUST NOW MAINTAIN MODEST INCREASE



DEFENSE PROGRAM IS $182 B LESS THAN ORIGINAL PLAN ... NOW BELOW PREVIOUS ADMINISTRATION PLAN

	1982	1983	1984	1985	1986
ORIGINAL REAGAN	222	255	289	326	367
PREVIOUS ADMINISTRATION	196	223	252	284	318
ACTUAL..........	214	240	258	287	278
DIFFERENCE TO ORIGINAL..	−8	−15	−31	−39	−89



FY 1986 DEFENSE OUTCOME NOT A PAUSE ... BUT A TWO YEAR REAL RETREAT

Third, I do not believe that it will be appropriate to cut the defense budget. I would like to show you, Mr. Chairman, and members of the committee, the President's original plan for defense was to rise at this rate right here. Even President Carter's proposal—this dashed line right here, was for defense spending to rise. It is the lower level of this shaded area that represents the path of defense appropriations over the past several years.

DEFENSE BA BELOW CARTER BUDGET

As you can see, while it grew, defense budget authority is actually now below the level asked for by President Carter's budget. In real terms, again, in terms of budget authority, while it rose steadily, it has fallen over the past year, and it now is at a level that is very similar to the level experienced in 1984. So, in a sense we have had a 2-year sliding back in the defense budget.

I'll discuss further details on the defense budget later.

Chairman DOMENICI. Could I ask a question about that please?

Dr. MILLER. Yes, sir.

Chairman DOMENICI. Could you pull that chart and put the other one back?

I do not mean to argue about the so-called Carter budget, but basically that dashed line, Carter's budget, is the outyear projections using the outyear economic and inflation estimates that were in the then Carter budget?

Dr. MILLER. That is correct.

Chairman DOMENICI. Which are substantially different and make for more real defense than could have been obtained under the redline, is that correct?

Dr. MILLER. Yes, sir.

Chairman DOMENICI. I thank you.

Senator GRASSLEY. Well, how come you do not adjust them down for the change in inflation then?

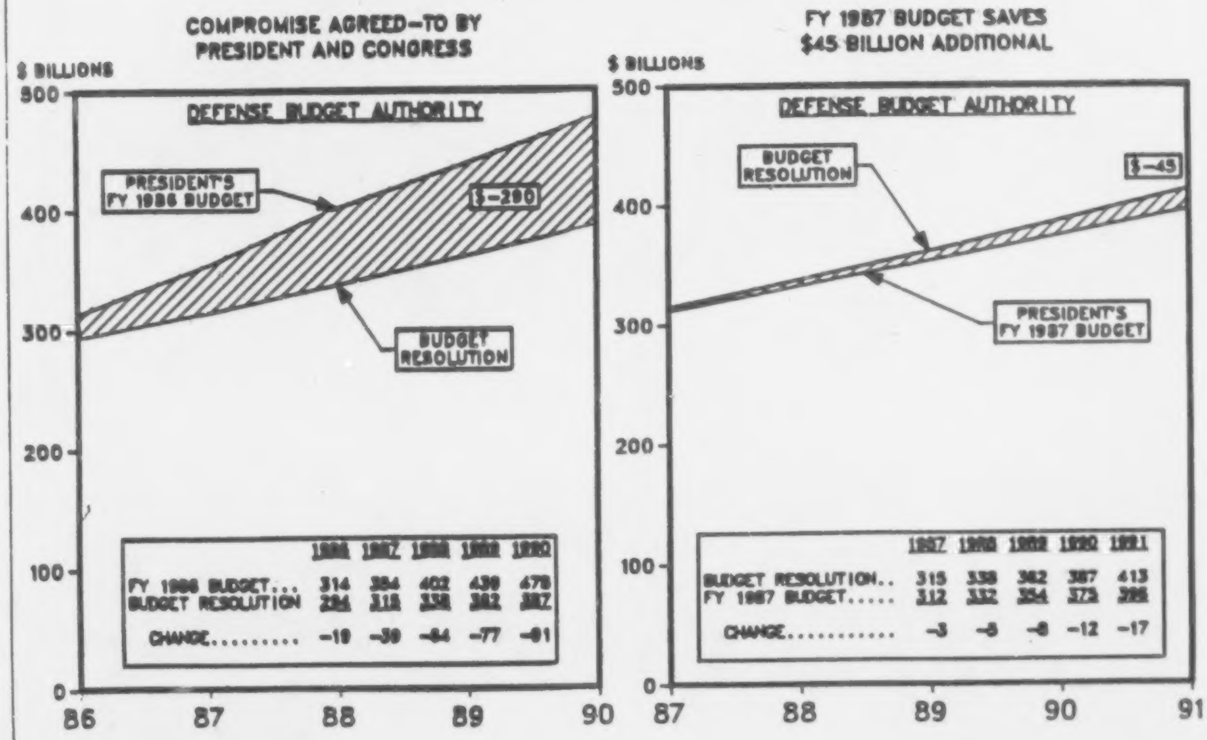
Dr. MILLER. Well, I have not adjusted them down but that could be done.

Let me say that in 1986 the President's budget called for the following expenditure for defense. The budget resolution agreed to last August was for this lower line here. And the difference between these two represent a $290 billion shortfall in defense budget authority, again between what the President asked for in his 1986 budget and what he agreed to last fall in the congressional budget resolution for the period of 1986 to 1990.

Beyond that, let me make the following point and this will surprise a lot of people—this congressional budget line is replicated on the top of the right side of the chart. The President's budget for 1987 is below the congressional budget resolution line. The reason is as follows—we, the Defense Department and OMB, calculated what would be necessary in terms of appropriations to give a 3-percent real increase. We made adjustments in military pay and civilian pay and we made adjustments in the special inflation factor, and in that way, are able to save $45 billion over the period 1987 to 1991.

The President's request for defense is below, in nominal terms, what the President agreed to in the congressional budget resolution last August.

LAST YEAR'S DEFENSE COMPROMISE SAVED $290 BILLION: FY 1987 BUDGET SAVES ANOTHER $45 BILLION


COMPROMISE AGREED-TO BY PRESIDENT AND CONGRESS

FY 1987 BUDGET SAVES $45 BILLION ADDITIONAL

	1986	1987	1988	1989	1990
FY 1986 BUDGET...	314	354	402	439	478
BUDGET RESOLUTION	294	315	338	362	387
CHANGE..........	-19	-39	-64	-77	-91

	1987	1988	1989	1990	1991
BUDGET RESOLUTION..	315	338	362	387	413
FY 1987 BUDGET.....	312	332	354	375	396
CHANGE............	-3	-6	-8	-12	-17

Chairman **Domenici**. Now, could I put this question to you in another way with reference to that whole block, how much, how many dollars is in all of that?

Dr. **Miller**. $290 billion.

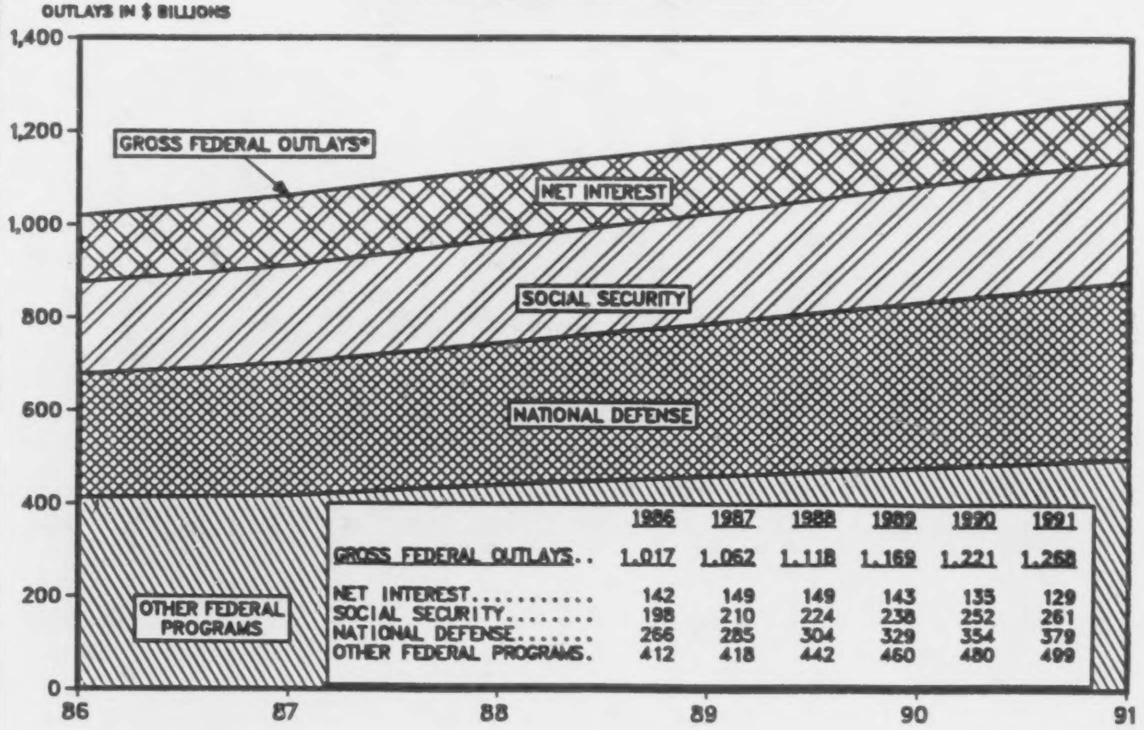
Chairman **Domenici**. Now, for our purposes are we saying that the budgets OMB Director Stockman submitted for the President had all of that in defense for those years for purposes of determining how we could get toward a balanced budget?

Dr. **Miller**. The $290 billion represents the difference between the estimates for defense budget authority contained in the 1986 budget for the years 1986 through 1990 and the policy in the 1986 budget resolution projected through 1990.

This chart here, Mr. Chairman, and members of the committee represents the simple way of looking at total outlays by the Federal Government. Part is paid in net interest, part in Social Security, part in national defense and the rest, I will call all other Federal programs, for the moment.

This is the current services baseline for the Federal Government. And if I could put this right below and put up another chart, Mr. Chairman, what I would like to do is to show you what total spending looks like under the President's fiscal year 1987 budget and you can make a comparison.

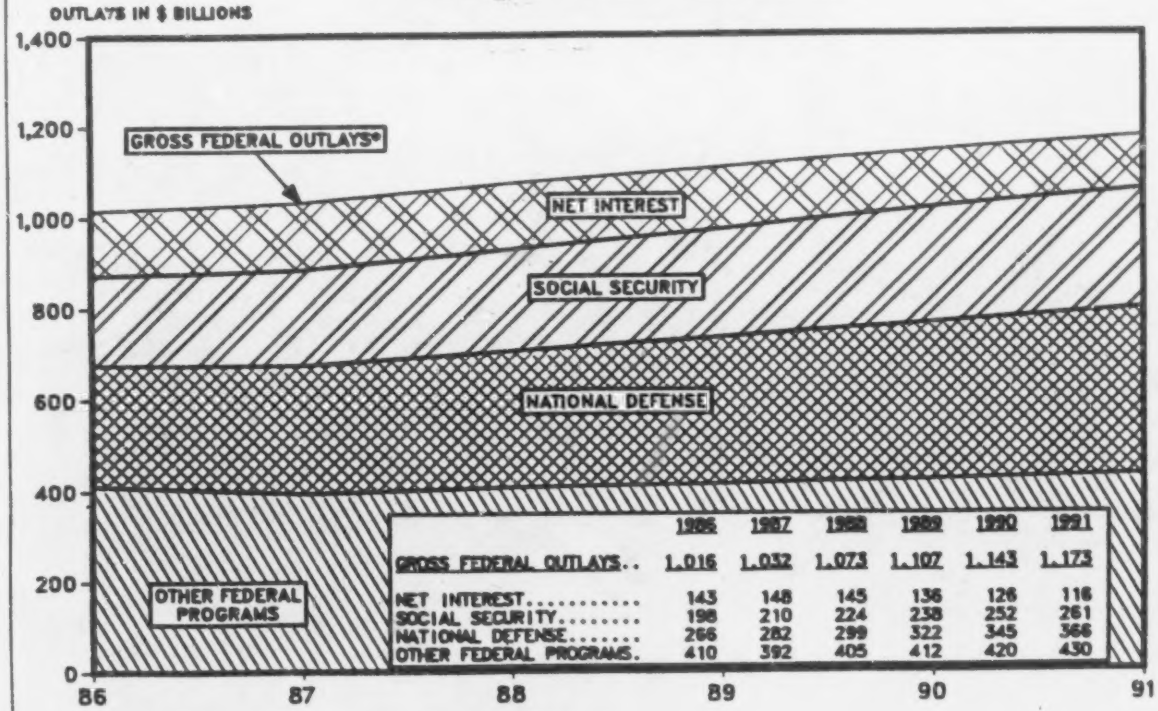
MAJOR BUDGET COMPONENTS: CURRENT SERVICES BASELINE



	1986	1987	1988	1989	1990	1991
GROSS FEDERAL OUTLAYS..	1,017	1,062	1,118	1,169	1,221	1,268
NET INTEREST...........	142	149	149	143	135	129
SOCIAL SECURITY........	198	210	224	238	252	261
NATIONAL DEFENSE.......	266	285	304	329	354	379
OTHER FEDERAL PROGRAMS.	412	418	442	460	480	499

* EXCLUSIVE OF UNDISTRIBUTED OFFSETTING RECEIPTS

MAJOR BUDGET COMPONENTS: PRESIDENT'S FY 1987 BUDGET



	1986	1987	1988	1989	1990	1991
GROSS FEDERAL OUTLAYS..	1,016	1,032	1,073	1,107	1,143	1,173
NET INTEREST............	143	148	145	136	126	116
SOCIAL SECURITY.........	198	210	224	238	252	261
NATIONAL DEFENSE........	266	282	299	322	345	366
OTHER FEDERAL PROGRAMS.	410	392	405	412	420	430

* EXCLUSIVE OF UNDISTRIBUTED OFFSETTING RECEIPTS

Senator LAUTENBERG. Can I ask an informational question, if I might please?

The baseline that we are using is the OMB baseline?

Is there a little debate concerning CBO and OMB baseline figures?

Dr. MILLER. CBO and OMB do not have the same baseline figures. My understanding is that the only real difference is the question of how to treat defense. So except for the defense numbers, I think the baselines are very close. They use basically the same concept, adjusting the 1986 level for inflation so as to maintain a constant real program level.

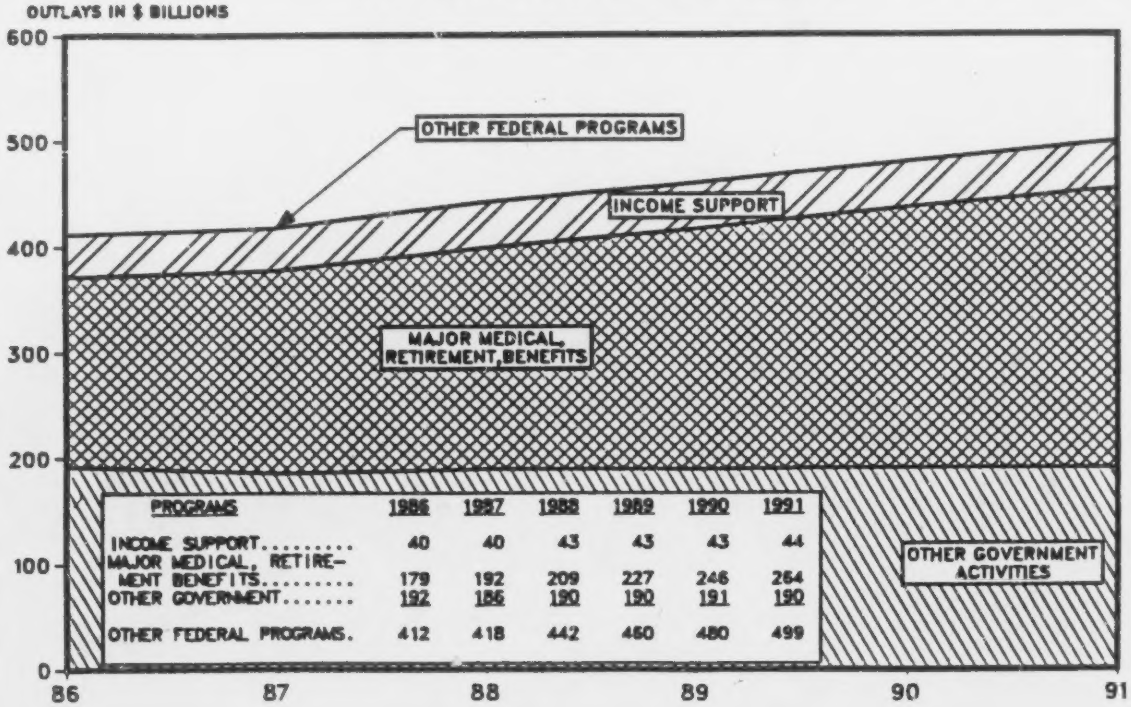
Senator LAUTENBERG. But we are working with OMB figures are we not?

Dr. MILLER. Yes, that is right.

As you can see, they are very close and, just by visual inspection, both the President's budget and current services call for an increase in nominal expenses over the fiscal year 1986 to 1991 time period.

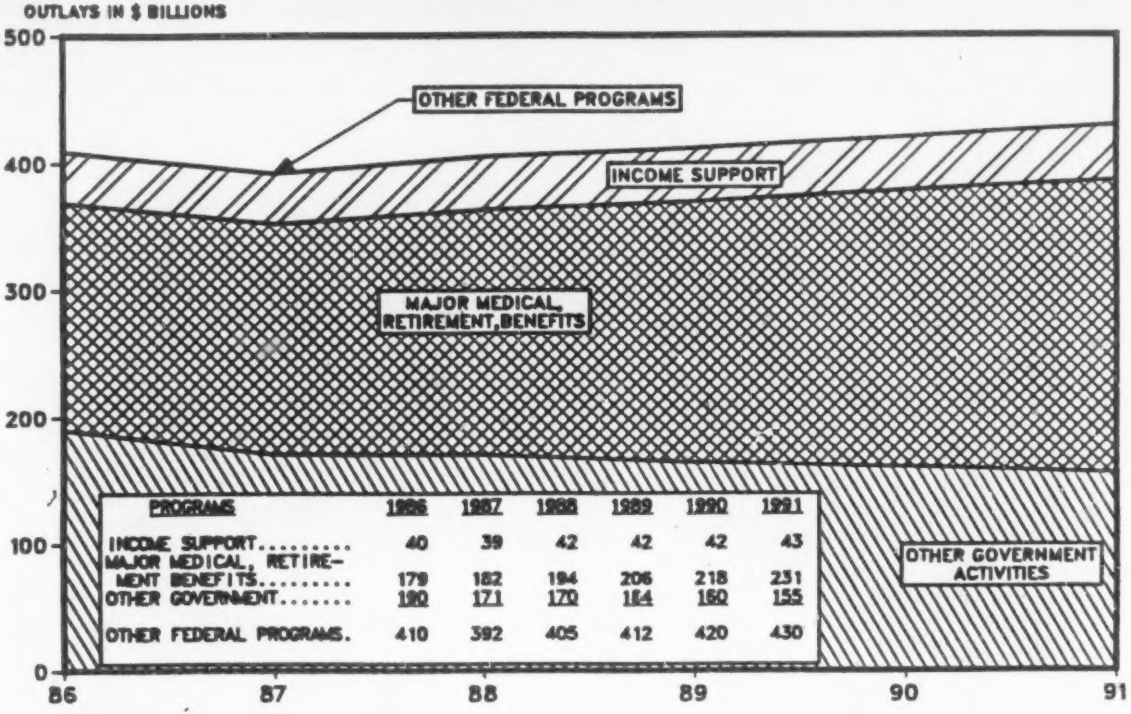
Now, let's look at the lowest area, other Federal programs, since there is not much that can be done about net interest, and the President, in a bipartisan implicit agreement, decided that we are not going to touch Social Security, and I have told you about the defense numbers. We need to realize some savings from the rest: We need a total reduction of $38 billion; we subtract $6 billion in revenue from that, plus $3 billion of savings from our national defense for fiscal year 1987 and $1 billion from debt service savings. And we have got about $28 billion of savings that we have to have from these areas. And you can think of these as divided into low-income support, major medical and retirement benefits, and all other Government activities.

CONTENT OF OTHER FEDERAL PROGRAMS: CURRENT SERVICES BASELINE



PROGRAMS	1986	1987	1988	1989	1990	1991
INCOME SUPPORT..........	40	40	43	43	43	44
MAJOR MEDICAL, RETIREMENT BENEFITS..........	179	192	209	227	246	264
OTHER GOVERNMENT........	192	186	190	190	191	190
OTHER FEDERAL PROGRAMS.	412	418	442	460	480	499

CONTENT OF OTHER FEDERAL PROGRAMS: PRESIDENT'S FY 1987 BUDGET



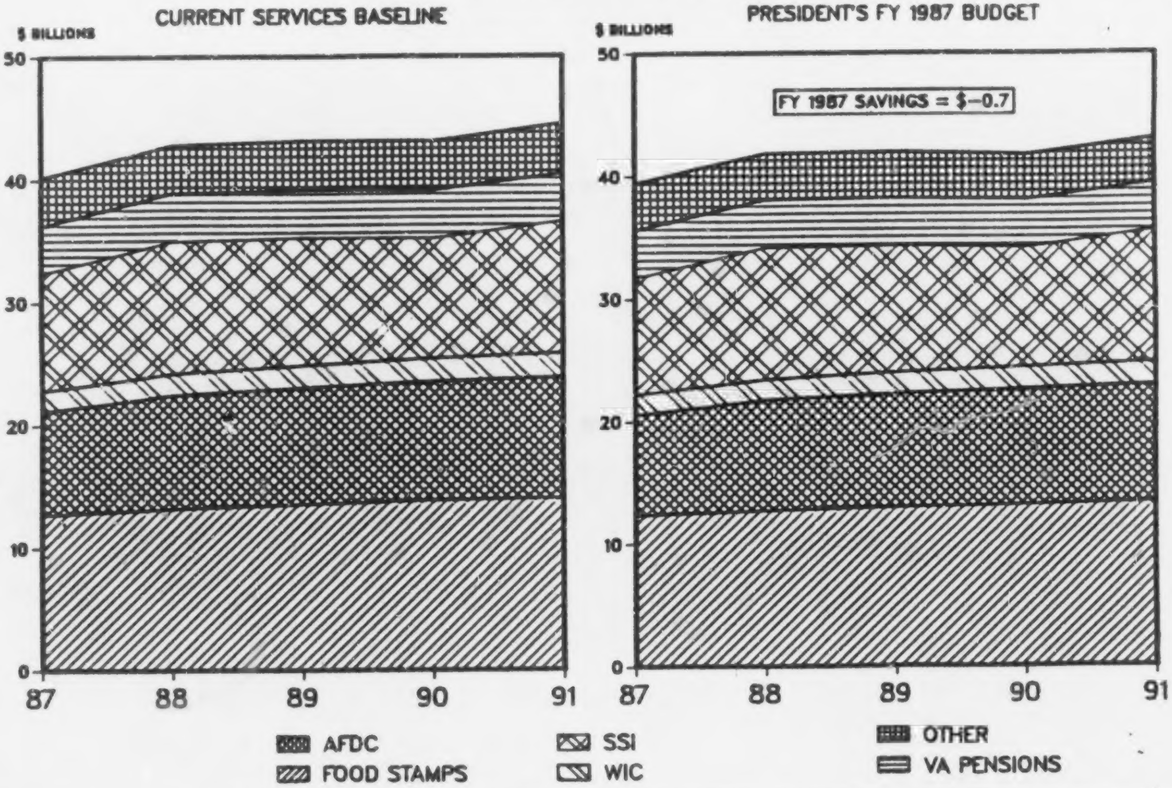
PROGRAMS	1986	1987	1988	1989	1990	1991
INCOME SUPPORT..........	40	39	42	42	42	43
MAJOR MEDICAL, RETIREMENT BENEFITS.........	179	182	194	206	218	231
OTHER GOVERNMENT........	190	171	170	164	160	155
OTHER FEDERAL PROGRAMS.	410	392	405	412	420	430

Now, this is the current services baseline for that lower portion of total spending.

Now, what I would like to do is to compare this, which as you can see is a fairly constant amount, visually with the President's proposal for the same period. The chief difference is that under current services, this spending is virtually constant from 1986 to 1987, while, under the President's budget there is a slight diminution. Under both current services and the budget, it continues to rise thereafter.

Now, what I would like to do at this point, is to break down each of these components and compare current services with the President's budget.

INCOME SUPPORT FOR NEEDY: PROTECTS BASIC BENEFITS



Low-income maintenance programs consist of AFDC, foodstamps, SSI, the WIC Program, VA pensions, and other programs. Under current services it looks like this and under the President's budget, it looks almost exactly the same. The reason is that very little savings are going to be obtained from this low-income portion of the budget.

Senator EXON. Question?

Chairman DOMENICI. Go ahead, Senator.

Senator EXON. That is dictated by Gramm-Rudman-Hollings is it not?

Dr. MILLER. What, sir?

Senator EXON. That those programs would not be cut.

Dr. MILLER. I do not understand. This is the current services baseline and this is the President's proposal contained in the fiscal year 1987 budget.

Chairman DOMENICI. Senator, I think that I understand your question.

He has not prepared for us a budget that would result if we automatically sequestered in August and September, because this is the alternate budget recommended. Now, we will have somebody do that so we will all know it.

Yes; Senator Hart.

Senator HART. Mr. Miller, do these charts in any way calculate the rather large increase in the number of people receiving benefits in these programs?

Dr. MILLER. No; it does not do that.

Chairman DOMENICI. OK.

Dr. MILLER. Of course that would be true in current services and the President's budget.

Chairman DOMENICI. I do not think that is a correct answer, is it?

Current services for an entitlement type program, includes both the automatic increase and the increased caseload.

Dr. MILLER. That is right.

Chairman DOMENICI. So, the answer to that question is on the left side, yes, it does include additional people does it not?

Dr. MILLER. Oh, yes, it incorporates the greater caseload.

I thought that you asked whether I had drawn a graph of the increased caseload? And I have not.

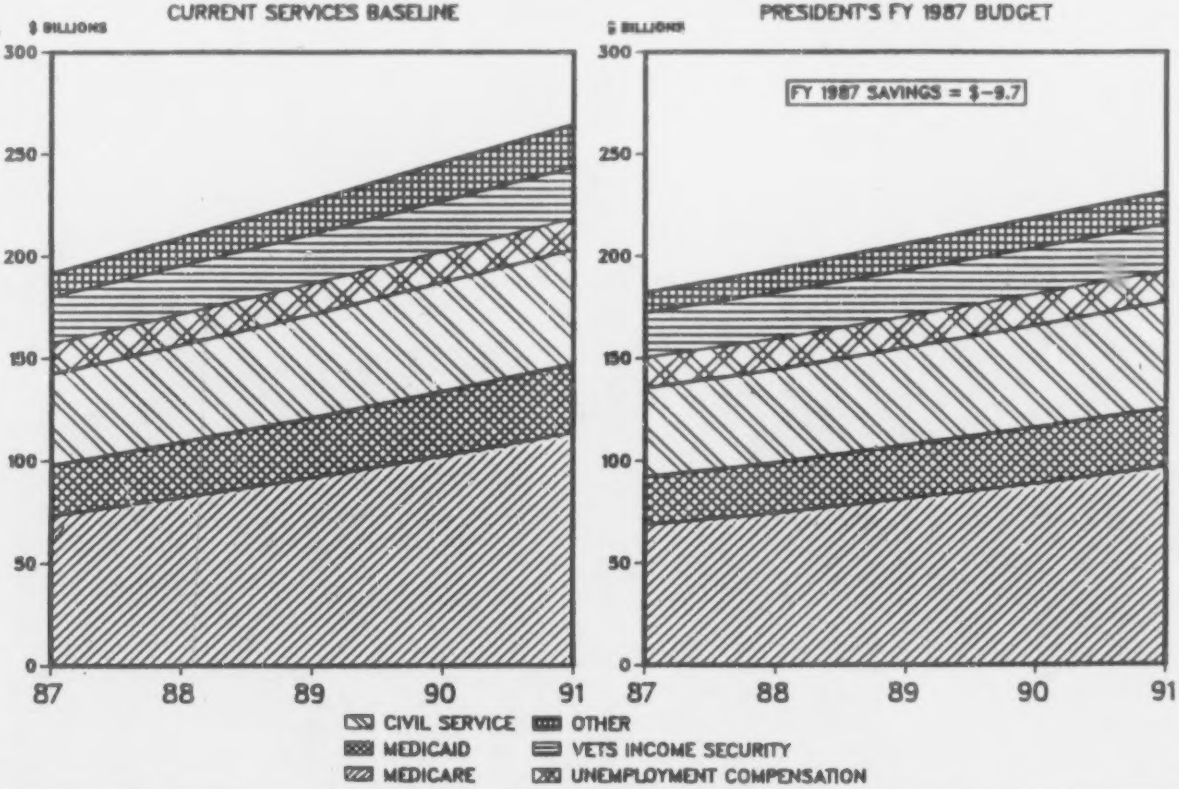
Senator HART. No.

I said do these charts in any way take into account the fact that a substantially increased number of people are demanding services from these services?

Dr. MILLER. That is true from this side, and we believe that is true on this side as well, because we have designed the $700 million savings in such a way that it will not reduce the services given to the consumers of those services. Our proposed funding will incorporate the increased caseload.

This next chart takes that second area, which includes Medicare, Medicaid, retirement and other benefits programs and you see there is a slight reduction. Keep in mind, the $700 million reduction was out of a base of $40 billion. Now, we see a 1987 reduction here of about $10 billion out of a base of some $180 billion.

MAJOR MEDICAL, RETIREMENT, BENEFIT PROGRAMS AND PAY RAISES: PROPOSES MAJOR REFORMS; LIMITS COLAS AND PAY RAISES



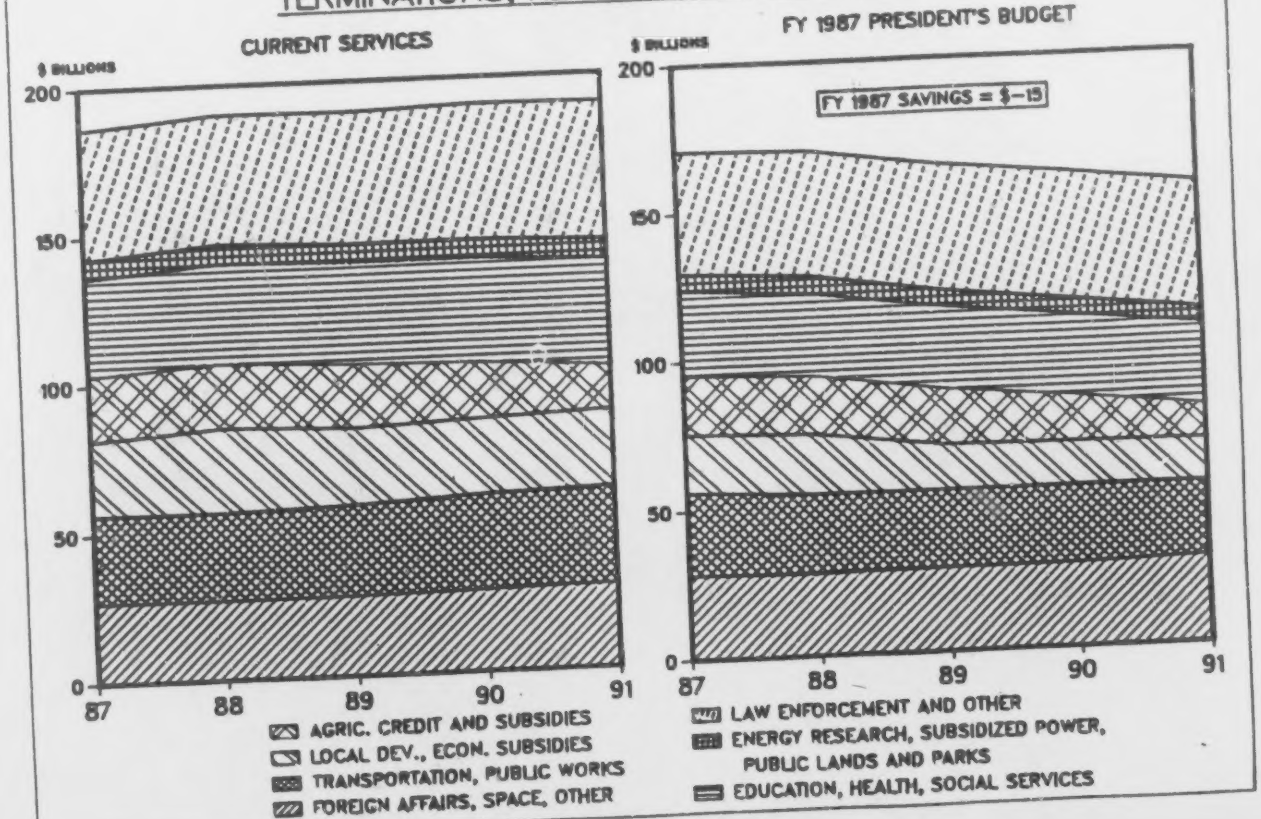
And you can see there is some difference, largely in civil service and military retirement, Medicare, and Medicaid. About $5 billion in savings will be from Medicare. We attempt to achieve this by increasing the incentives for hospitals to be more cost-effective and other kinds of reforms directed toward reducing the costs of providing the services to consumers of those services, but we do not remove people from the rolls. In Medicaid, we ask the States to find more cost-effective ways of acquiring the services, and we give them some flexibility that they have not had before.

We freeze civil service retirement COLA's and make future COLA's equal to the cost-of-living minus 2 percent.

The third category is the category that would be hit the hardest. And that is all other, ranging from transportation to law enforcement to education. Under the current services budget there would be a slight rise between 1987 and 1988 and then virtually a constant amount over the period of 1988 to 1991. And under the President's budget, it would be rather constant between 1987 and 1988 and then fall after 1988. We would anticipate savings of approximately $15 billion in 1987, but again, on a base of about $186 billion and this constitutes less than 10 percent, certainly not Armageddon.

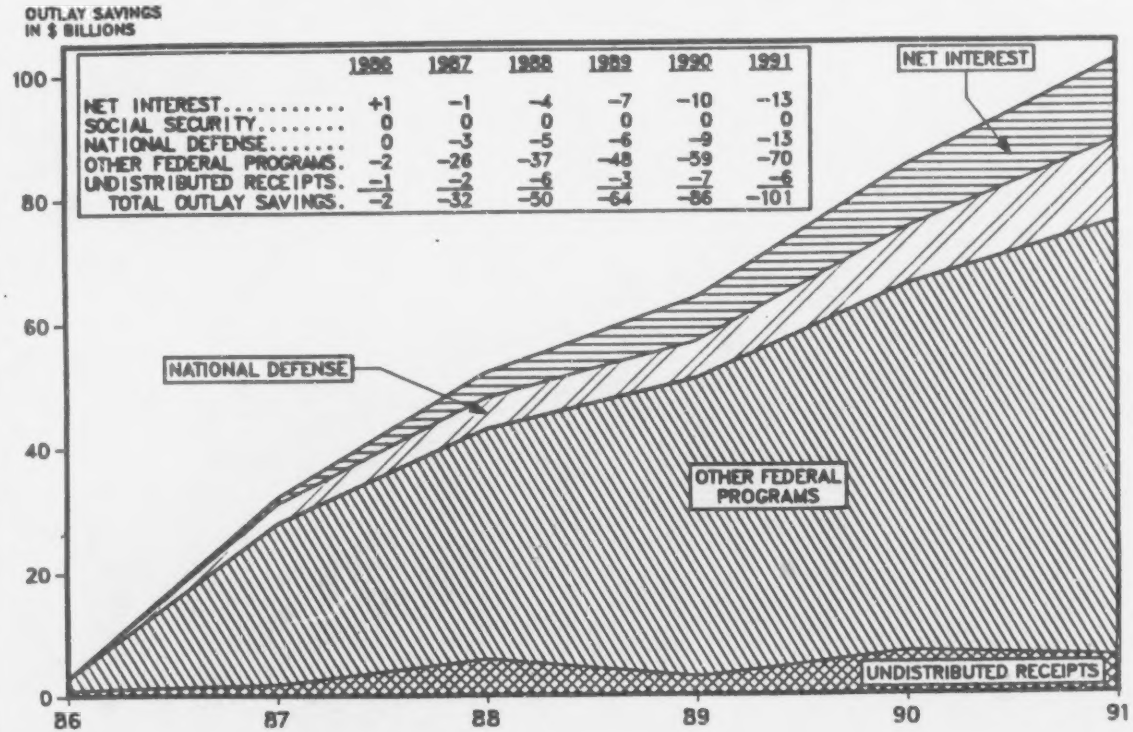
A lot of programs here will survive virtually unscathed. Some of these programs that we feel do not deliver goods and services to the taxpayer commensurate with their cost will be terminated.

OTHER GOVERNMENT ACTIVITIES: TERMINATIONS, REFORMS, AND RESTRAINT



This final chart is designed to indicate the sources of the savings. We put aside for a moment the $6.3 billion in savings that has come from the increased revenues. These are the savings on the outlay side.

As you can see, there is a wedge of interest that we are saving over the period of the budget.



BUDGET SAVINGS BY MAJOR-BUDGET COMPONENT

	1986	1987	1988	1989	1990	1991
NET INTEREST	+1	−1	−4	−7	−10	−13
SOCIAL SECURITY	0	0	0	0	0	0
NATIONAL DEFENSE	0	−3	−5	−6	−9	−13
OTHER FEDERAL PROGRAMS	−2	−26	−37	−48	−59	−70
UNDISTRIBUTED RECEIPTS	−1	−2	−6	−3	−7	−6
TOTAL OUTLAY SAVINGS	−2	−32	−50	−64	−86	−101

The reason is that by getting the deficit down, we have less debt to service, and so, debt service expenses are lower.

I would like to note that we expect the real rate of interest to be falling somewhat due to the lower deficits we propose. Because of that the cost of servicing the debt is also reduced. I think that goes to the question that I was asked before, how can total debt service expenses go down, even though the total debt is rising. Since both current services and the budget estimates are based on the same economic assumptions, the true reduction in debt service expenses is probably understated.

We have national defense savings for the reasons that I outlined before. Every year the amounts for national defense would be lower and the increase for the subsequent year, in order to realize a 3 percent real increase in defense, would also be lower.

Let me direct your attention to the bottom line here, these are undistributed offsetting receipts, things such as selling major physical assets, Outer Continental Shelf receipts, and employer share of employee retirement. As you see, the savings here rise through 1987 to 1988. One reason for this is that when you sell assets it is not easy to package their sales immediately and so some of the assets will be sold out over this period of 5 years.

This area right here is what represents the outlay savings in all other Federal programs, and that is only $26 billion. Part of this savings is accounted for by increased offsetting receipts which are netted against outlays in the appropriate function. If an agency charges increased user charges that further reduces the amount of programmatic cuts that would be necessary in order to realize the savings to meet the $144 billion target for fiscal year 1987 and the target of the balanced budget by 1991.

As you recall our estimate of the current services deficit would fall down to about $105 billion by 1991, and so therefore, the amount of savings that we would have to record to get us up to the target is the $101 billion in outlays plus the increased revenues for 1991, which, as I recollect, is about $4 billion. And this would result in a slight surplus for us at that point in time.

PROGRAMMATIC CUTS LESS THAN THOUGHT

If I could just recapitulate, the budget does not cut nearly so much programmatically as it is perceived by many to have cut. First of all, the amount of savings needed is not $70 billion, not $60 billion, not $50 billion, not $40 billion but $38 billion.

INCREASED REVENUE

Second, $6.3 billion of the savings are increased revenue, and several billion dollars, $5.6 billion are from increased revenues from asset sales, increased user charges and that sort of thing. Savings of $3 billion comes from a defense cut and $1 billion from reduced debt service. The amount in which you have to realize cuts in the nondefense programmatic area is more like $22 billion. And that is out of a total budget of almost $1 trillion. It seems to me that $22 billion of nondefense programmatic savings is hardly the end of the world. It sounds to me, if I could just be so bold as to say, that for what we could receive in return for not having to raise taxes, not having to hit Social Security, not having to weaken our defenses at a time when the Russians are at the bargaining table and our allies need to have the consistency from us and not moving into the programs for the poor and the elderly, that is a small price to pay.

Thank you, Mr. Chairman.

Chairman **Domenici**. Thank you very much. I just have one question and then Senator Grassley, I am going to yield to you.

HOW DEFENSE FITS CURRENT SERVICES BUDGET

When you do your current services graphs, and compare current services under this budget and current services now, how does defense fit in to the two of those?

Dr. **Miller**. The assumption that we made for defense and defense only is that we go to the defense top-line that was contained in the congressional budget resolution which was for function 050 $323 billion in budget authority. Then, we were able to save $3 billion by reestimating the special inflation factor which was at 1.3 percent but which we and defense agreed was not needed at that level.

We maintained the concept of the special inflation factor, but it is at 1 percent. Also, we lowered the military pay from the earlier estimate to 4 percent.

Senator **Chiles**. Mr. Chairman, as we know, those numbers did not take into account the sequester amount and CBO did work out of a zero real growth. I would just like to insert in the record a table prepared by the Senate minority staff that shows that the real growth would be 8.4 percent working of our CBO numbers rather than the 3 percent.

[The following was submitted for the record by Senator Chiles:]

FUNCTION 050

[In fiscal years and billions of dollars]

	1936 Post GRH	1986 Appropriation	1987 Proposal	Percent Real growth 1987 over 1986 post GRH
Budget Authority	286.1	299.4	320.3	8.4

Note.—FY 1987 real growth is 8.4 percent—not the 3 percent DoD claims. DoD is using last year's appropriated totals, not the Gramm-Rudman base level.

Chairman **Domenici**. That is of of the sequestered appropriated level?

Senator **Chiles**. Yes, sir.

Chairman **Domenici**. Let me indicate to the committee I am going to let Senator Grassley or Senator Symms chair for about 5 minutes. I will return rather quickly.

Whichever of you would like to do that, proceed with the questioning.

Senator Grassley, do you want to question now and chair for me and then Senator Chiles is next and I will be right back.

Senator **Grassley** [presiding]. Dr. Miller, I have some questions somewhat along the line of those I asked of the committee in my opening statement. This is so that you will know where I am coming from.

But in the first instance, before I even get to those specific questions, I would like to have an explanation. Maybe you did it while I was out, and if you did, I would just ask you to repeat it.

EXPLANATION OF DEFENSE REAL GROWTH

How do you call the defense figures 3 percent real growth when, in fact, it is 8⁵⁄₁₀ percent above the figures that we are now spending and the President has made two decisions, in the interim, of signing two bills that lowered the baseline down from what it was. It is down to $286.1 now.

Dr. **Miller**. Well, I do not want to get into a semantic debate over the matter. As I have always said, and we have represented, the President will ask for a 3-percent increase in defense over the CBR level. It is equivalent to a 3-percent real increase over the level at which defense was appropriated in fiscal year 1985. So, it is only 3 percent over the 1985 level, although, as you say, I think that it works out to be about an 8-percent increase over fiscal 1986, after the sequester and also, after Congress failed to deliver to the President in the continuing resolution the full amount of the zero increase that he bargained for in the congressional budget resolution. It is a 3-percent increase over what he would have received had Congress met its obligation to him, in exchange for his agreement to support the congressional budget resolution.

The figures are what they are.

But it is very difficult, as you know, Senator Grassley, to reduce defense since the demand for it is not entirely a function of domestic considerations. It is based on what the threats are and what the general posture is. I think defense is, under almost any philosophy of government, the primary function of government.

DEFENSE HAVING TROUBLE SPENDING MONEY

Senator **Grassley**. Has OMB done any work to determine the difficulties that the Department of Defense is having spending the money that they have been given already?

Dr. **Miller**. Well, we could give you an explanation of why on occasion you have unobligated balances. It is not that they have had difficulty. I am sure that we would not characterize it as difficulty of spending appropriated moneys.

Some commitments are made and for various reasons are not carried out. They are intended but are not executed.

Senator **Grassley**. Well, how confident are you that the money is being spent efficiently?

Dr. **Miller**. We work on that very hard and demand a lot of information from the Defense Department. We pepper them with questions about alternatives. We try not to get into second guessing too much on the question of military strategy but we do, as accountants would or planners would, try very hard to look at the way that they go about procuring their wares.

Also keep in mind, that as you know, well, Senator Grassley, the Packard Commission is going to be making its recommendations soon.

We look forward to evaluating that report to see if there are any ways in which we could further reduce the cost of meeting our defense requirements.

DEFENSE UNOBLIGATED BALANCES

Senator **Grassley**. In answer to my first question, you did have some explanation for the unobligated balances. But the money that they have not spent, and the lack of speed in their spending it, is based on their rhetoric for the need for it.

There has been growth in this figure in recent years. Now, that surely ought to alarm anyone in the administration.

Dr. **Miller**. Well, let me say that it is a two-way sword and one might say, well, why did you ask for appropriated amounts that you ended up not spending?

On the other hand, I would congratulate the Department of Defense for not spending it in a willy-nilly fashion. If you end the year and you do not have the commitments that you anticipated making, it is better to return those moneys to the Treasury I think.

Senator **Grassley**. You know, the environment that you and I are referring to here now is still in light of an acknowledged fact that they, you know, at the tailend of a fiscal year just try to get the money obligated, get it out the door as fast as they can. You still end up with these tremendous large numbers for unobligated balances and then more important, recent years' growth in that area.

So, I just want to put it in the context that it really ought to be in.

It seems to me like the emphasis that this administration has put on no tax increase, which at least initially, I am not going to argue with, ought to be considered in light of these unobligated balances there. Whether or not taxes are really needed.

And that is my last question, because the red light came on. Surely, you just cannot put defense off and say that the growth there is all right and just have recission after recission, after recission, in every other area of government.

Dr. **Miller**. Well, I would just point out that the presence of any unobligated balances means that outlays for the year were lower than they might well have been. So, in a sense, it does not really cost a lot to authorize more defense spending than they end up spending.

Keep in mind that you have multiyear appropriations and unobligated balances can simply arise because the flow or the development of a weapons system takes longer than you had anticipated.

Cap, Secretary Weinberger, has been working very hard to avoid cost overruns. He has been monitoring that and trying to manage that very carefully.

Sometimes when you do a good job in things, it ends up with some statistics creating certain statistical abberations which could suggest that there are problems, but I respect him for moving forward on these things, even though it raises problems.

I think that the unobligated balances situation is probably more a reflection of some uncertainties with respect to the multiyear appropriations and the longer time it takes to develop some of these programs and the uncertainties attendant with them, than any sort of perception that hey, let's go in and see what we can do to get as much money as we possibly can and then try to shovel it out the door.

It makes little sense to do that and I have not observed the Department of Defense engaging in that kind of behavior, although we will look at it carefully.

CONTINGENCY PLAN FOR WRONG GROWTH RATE?

Senator CHILES. Dr. Miller, the administration's estimate for real growth rate for GNP is about 4 percent a year for the next 5 years.

That is the same estimate you used last year when the actual growth rate turned out to be 2.3 percent.

Your assumptions for the next 5 years are substantially more optimistic than CBO and even more optimistic than the private forecasters. Unlike previous years, however, if the forecast is wrong, we could pay a heavy price.

If we adopt everything in the President's budget and your forecast is wrong, we would need to cut more in September or face an across-the-board Gramm-Rudman-Hollings sequester in October.

According to the President's budget document, if the economy continues at 2 percent real GNP rather than 4 percent as you predict, we would miss the Gramm-Rudman-Hollings target, by about $20 billion. As a reasonable manager for the Federal Government's budget, you must have some contingent plan to deal with that possibility.

Do you have additional cuts which you would plan to send to us in September if your current economic forecast turns out to be too optimistic?

Dr. MILLER. Well, let me just say, we have an estimate, Senator, on page 2-29 of our budget document, that a sustained 1 percent lower real growth in GNP beginning in October 1986, would reduce receipts in 1987 by about $6.2 billion and increase outlays in 1987 by $1.1 billion.

So, $20 billion may be a little high. But you are absolutely right. We have very little margin of error. Our estimate of the deficit is $143.6 billion, which is only $400 million below the target of $144 billion.

Now, I would point out that if it turned out next fall that our estimate of the budget deficit were $10 billion more, and I do not encourage us to think this way, but if it turned out that our estimate or the average between the CBO and the OMB estimates was $153.6, even though that would be almost $10 billion in excess of the Gramm-Rudman-Hollings targets, there would not be sequestration because there is a $10 billion safety zone for the sequester.

NO CONTINGENCY PLAN

Senator CHILES. Do you have a contingency plan?

Dr. MILLER. I do not have one right now. There was no need to draft one up. If we do see the economy deteriorate, or have reason to believe that the economic performance of the economy in fiscal year 1987 will be poorer than what we presume, we will come in and ask for additional cuts.

Senator **Chiles**. When you start working on that plan, I hope you will let us know.

Dr. **Miller**. Let's just look at fiscal year 1987 and not the outyears for a moment. At the time that we came out and announced these assumptions, it was on the high side of the average of the estimates that had been bounding around. But that average has moved up toward our estimates. You know, the business of making these estimates is somewhat difficult, it is fraught with error because you never know for sure.

There were times, in the past, in the Reagan administration, when we underestimated growth, as well as times when we overestimated growth.

FIVE-YEAR EFFECT OF A SEQUESTER OF PROGRAMS

Senator **Chiles**. This would be a question that you would have to answer for the record, probably, but we would like to have your calculations on what would happen to both defense and nondefense programs over the next 5 years, if we had to achieve the Gramm-Rudman-Hollings balanced budget targets by sequestration alone?

If you would, please calculate for each of those 5 years, the amount of spending cuts in dollars and percentages of budget authority in outlays that would occur in each function and subfunction of the major programs. I think we need this information over the next few weeks as we go into markup to help us to know why we have to write a real budget and not lean back on the sequester orders to do the job.

Dr. **Miller**. Senator, we can do that for fiscal year 1987 fairly easily. For the outyears it is difficult because you would need to know the level of appropriations for the outyears and only Congress can determine that.

Senator **Chiles**. Well, if you just figured them from the baseline of the sequestered, of what happened on each year.

Dr. **Miller**. Well, I think that is a rather extreme assumption but I will be glad to do that for you.

[The following was subsequently supplied for the record by OMB:]

IMPACT OF SEQUESTER

The impact of a sequester for 1987 is currently being studied. We will send results to the committee when they are available.

Senator **Chiles**. All right.

You were asked at your last hearing, when you were here, to provide us with a State-by-State allocation of the fiscal year 1986 4.3 percent sequester.

Now, the President issued that sequester order last weekend, showing his decisions about the details of the cuts within accounts, so you should be able to provide that information.

Will we be able to get that prior to the President's order taking final effect on March 1?

Dr. **Miller**. I think so.

Senator, I beg your indulgence, and I appreciate your understanding that people at OMB have just been working very, very hard to produce these data. In some areas we can make those estimates and in some areas, it will be very difficult to allocate by State but we will do the best we can and give you the results.

[The following was subsequently supplied for the record by OMB:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

Honorable Lawton Chiles
United States Senate
Washington, D.C. 20510

FEB 24 1986

Dear ~~Senator Chiles~~ Lawton:

This is in response to your request for a "State-by-State allocation of the fiscal year 1986 4.3 percent sequester", made during the Budget Commmittee hearing on February 5th.

I have asked OMB staff to look into this matter and, unfortunately, for a number of technical reasons, it is not possible to develop State-by-State estimates of the effect of the Gramm-Rudman-Hollings sequester with an acceptable degree of accuracy. For example:

- The FY 1986 sequester process began well after the start of the fiscal year and otherwise sequesterable funds within some accounts had been obligated and expended before the sequester order was issued. An extensive, time-consuming survey of the agencies would be required to determine the State-by-State initial impact of the order. Arbitrary allocation factors will not produce reliable estimates.

- The regional impact of some types of spending depends upon decisions that will not be made until later and that cannot be forecast with certainty. This is particularly true of competitively awarded contracts and grants.

- The data sources containing State-by-State distributions of Federal activity, on which estimates of the regional impact of sequester would have to be based, are derived directly or indirectly from data on obligations. Obligations data cannot always be translated in any simple way to new budget authority or outlays, which are the primary sequester data. This is particularly true for data pertaining to a single year.

- The Gramm-Rudman-Hollings sequester, like a rescission, reduces the funds available for an account and, within the account, program, project, or activity. It does not change any of the existing rules of program administration, such as reprogramming. It is entirely possible and proper, therefore, that the post-sequester allocation of resources within an account will change to reflect changed circumstances. In such cases, the effect of sequester could be far outweighed by the effects of other factors.

- o There are special difficulties associated with the State-by-State effect of sequestration on defense procurement. For these contracts, data are not available on secondary or tertiary contracts even before sequestration. Moreover, State-by-State sequestration data would have to be developed for each of hundreds of program, projects, and activities. Such an effort would be extraordinarily complex.

- o For Federal civilian and military employees, the sequestration will also be carried out by the hundreds of programs, projects, and activities in accordance with the law. Information on the State-by-State location of Federal civilian and military employees in each of these activities is not available.

The Office of Management and Budget does prepare each year, primarily for the benefit of State governments, the Budget Information for States (BIS) report (copy attached), which contains State-by-State distributions of obligations for major Federal formula grant programs. The data contained in the BIS report consistent with the FY 1987 budget are post-sequester, but the report does not include all programs subject to sequestration. However, for the programs included, which account for 85 percent of total Federal grants to States, the funds available after sequester are shown.

The Gramm-Rudman-Hollings Act requires that the automatic spending reduction -- 4.9 percent for sequesterable defense funds and 4.3 percent for sequesterable nondefense funds in FY 1986 -- be applied uniformly by account and, within accounts, by program, project, or activity. This requirement is being carried out faithfully by the agencies, so I can assure you that no discretionary action is being taken that would favor one State relative to another. I am confident that the residents of all States are benefiting from the increased economic activity that seems clearly attributable to passage of the Act.

If I may be of any further assistance, please do not hesitate to contact my office.

Sincerely yours,

James C. Miller III
Director

Enclosure *

c: Honorable Pete Domenici

* Retained in committee files.

BUDGET AND STATE OF THE UNION INCONSISTENCIES

Senator **Chiles**. I thank you.

As I listened to the State of the Union message, last night and as I read the budget or start to read it today, I hear something of a different message.

Cuts in health programs, in 1987 are going to amount to about 28.5 percent of all deficit reduction. If we exclude the asset sales of the net interest reductions, that would be a cut of $8.1 billion out of a total of $28.4 billion.

And in biomedical research, the State of the Union said we will increase our competitive balance in the world by investment in growth industries. And yet, in the budget, biomedical research in the National Institutes of Health is cut by a half a billion dollars, back to the investment level of 3 years ago.

The State of the Union made a commitment to real and lasting emancipation for the poor and preserving the future of our children. The budget as I see it, cuts Medicaid $17 billion over the next 5 years, the program that provides basic health needs for the poor, the aged, and most importantly the little kids and infants who will not have a chance without our commitment to keep them healthy and growing.

In Medicare, the State of the Union message makes a commitment to providing affordable insurance coverage for catastrophic illness, a new direction in Medicare. The budget makes no mention of catastrophic illness, just a repeat of proposals to increase the cost of Medicare to the elderly making the current program unaffordable for many more elderly.

Total Medicare cuts—regulatory and legislative—are going to total $53.8 billion over the next 5 years. Of that amount, approximately $22 billion will come from increases in beneficiary cost-sharing.

How do we relate the message last night to what we now see in black and white on paper?

Dr. **Miller**. Well, I do not think that there is an inconsistency. A number of the savings that we are talking about are the type that we are going to improve service delivery and lower the cost of service delivery. There is not——

Senator **Chiles**. Well, do you think that you can cut as many as 10,000 full-time employees from the current Veterans Hospitals, nursing home care, by improved service delivery and not have a reduction in care?

Dr. **Miller**. Yes.

Well, also let me point out that while there is nothing in the budget for catastrophic medical insurance, the President's suggestion in the State of the Union did not necessarily suggest that there would be a federally subsidized program here. It was a question of how the Federal Government and the private sector could work toward that end.

There are no prior commitments or assumptions in this research that will be carried out by Dr. Bowen at the Department of Health and Human Services as to the precise dimensions of the program, of whatever program or solution or recommendations that they make to the President.

Senator CHILES. In a sense, you are saying you are going to shift to just a regulatory method and you are going to shift to the private pay for the payment of these services?

Dr. MILLER. Well, if it is a private program, it will be covered by the private sector without public subsidy.

But you asked if there was an inconsistency between the President's statement last night and not having some account set aside in the President's budget for the outyears of 1987 and beyond for this program.

And I do not think necessarily that there is an inconsistency.

INCREASE IN FOREIGN AID PROGRAMS

Senator CHILES. Dr. Miller, for the past several years, I have been watching the amazing growth of foreign aid programs. In fact, foreign aid has been one of the fastest growing areas of the Federal budget. A 70-percent increase between 1980 and 1985. This certainly reflects the President's strong commitment to foreign aid.

However, this year, in a budget that drastically cuts domestic programs, again, we see a 12.5-percent increase in the gross budget authority for foreign aid.

In the light of all of our budget priorities, do you think that we really need a 33-percent increase in the worldwide grant of military assistance; an 89-percent increase in military aid for Africa; 50-percent increase in military aid for Southeast Asia; 22-percent increase for multilateral banks and a 15-percent increase for cash transfer funds?

Dr. MILLER. Senator Chiles, assuming those figures to be correct, the simple answer is yes.

Those figures were agreed upon after extensive discussion with the Secretary of State and in discussion with other officials of OMB and the Department of State and the National Security Council and the President of the United States. I think an explanation for each particular item that you requested, would probably be better handled by the Secretary of State, himself, who may or may not appear before this committee. I do not know, but perhaps a request for an explanation from him might be appropriate. At some later time, I would be glad to respond to it in writing, if you would so desire.

FOREIGN AID SUPPLEMENTAL FOR EMBASSY PROTECTION

Senator Chiles, could I point out also that in this year's supplemental, the 1986 supplemental, it is primarily for the security of our American installations abroad.

As you know, we had the terrible bombing in Lebanon, and we have had threats in other places, and in fact, I was having breakfast with the Secretary of State, yesterday morning and he was on his way to testify before Congress on that very point.

Some of those moneys are for security.

Chairman DOMENICI. Senator Quayle, you may proceed.

WITH MINOR EXCEPTIONS PRESIDENT'S BUDGET WILL PASS

Senator **Quayle**. Thank you very much, Mr. Chairman, and welcome to Dr. Miller. I'm sorry, I was not here for your opening statement, however, I just wanted to congratulate you for at least coming up with a road map on how we get from here to there in meeting the Gramm-Rudman targets, given some fairly tough restrictions; those being, that you're not to touch Social Security, that you're not to look at revenues, and that defense ought to continue at 3 percent real growth.

Obviously, there will be changes; there will be compromises. You'll hear a lot of statements, such as "dead before arrival"—a new term this year, rather than "dead on arrival."

But once we get beyond the initial reactions and statements, and sit down and work with this budget, I think you'll find out in the final analysis that it won't be changed all that much. Just going back and looking at last year's budget, 10 out of 18 functions varied less than 10 percent from what the President recommended.

There were some minor changes, particularly the general fiscal assistance function, but generally the priorities will stay in tune with the direction you're sending us. Domestic spending has been an area which has increased over the years. Defense spending, particularly in the last couple of years has not necessarily increased compared to the domestic side of the ledger.

I believe about one-third of the additional spending obligations that the Government has incurred has been in defense, and two-thirds has been in domestic.

So I think you've got your eye on the right ball.

I was really struck by this latest chart you put up where the defense cuts are going to come out in the next 5 years to an additional $190 billion from 1985 through 1990. Is that correct?

Dr. **Miller**. No; it's $45 billion over that period.

Senator **Quayle**. $45 billion over the next 5 years?

Dr. **Miller**. Yes; relative to the congressional budget resolution.

Senator **Quayle**. Relative to what we passed last year? How about what the President submitted in 1985?

Dr. **Miller**. Much larger than that.

Senator **Quayle**. Was that the $190 billion figure?

Dr. **Miller**. It was $290 billion to my recollection.

Senator **Quayle**. OK. If you add the $290 billion figure that the President is willing to change, with the $170 billion that he's already changed in the last 4 years in defense spending, you're looking at $360 billion in defense cuts. Now, at some point even my good friend over here, Chuck Grassley, is going to say enough cuts in defense is enough. Now, I hope we never get to the day where he says that, because I will have a difficult time wondering how we got there. But we may be getting that far if we're going to look at the magnitude of $360 billion in cuts from what the President recommended.

There are certain limitations and certain risks that are calculated by going in this direction.

We'll have to wait and see where the Congress comes out on this, but I, for one, will be trying to maintain as close to that 3-percent growth mark as possible.

Now, we may not be able to get it. If we can't we'll have to come up with the best we can.

FORCING SEQUESTER IRRESPONSIBLE

The one thing that I'm curious about, Dr. Miller, is, if we get into a stalemate here in Congress, which I think is a real possibility this year—it always is in an election year—and this year you have the choice of not getting a budget resolution, or reverting back to the Gramm-Rudman-Hollings measure. I think that's a distinct possibility that we won't see a budget resolution this year, that the Gramm-Rudman-Hollings sequestration will be the budget resolution, and we'll work off of that.

How unacceptable to you is Gramm-Rudman-Hollings triggering a sequester that will be carried out this fall?

Dr. MILLER. Well, I think if we ended up having to sequester, it would be evidence of irresponsibility on the part of Congress, and arguably the President would be blamed as well.

Although, let me emphasize that if the Congress adopts the President's budget, there will not be sequestration.

So, I would be in the position of saying, if we do have sequester, it's because Congress didn't respond to the President's budget.

Senator QUAYLE. Obviously, if the Congress would adopt the President's budget, or a budget similar to it, that meets the targets, then you don't have the triggering of Gramm-Rudman-Hollings.

I guess my query to you is that if Congress gets bogged down in the budget you can say that's irresponsible. however, how unacceptable are those automatic cuts to the administration if there is not a resolution by September—time for sequester.

Dr. MILLER. Well, Senator, I would just say that——

Senator QUAYLE. You don't want to answer that?

Dr. MILLER. Well, I don't want to answer it really very——

Senator QUAYLE. You don't want to answer it.

Dr. MILLER. But I will say it's unacceptable.

Senator QUAYLE. The Gramm-Rudman-Hollings trigger is unacceptable.

GRAMM-RUDMAN-HOLLINGS CUTS UNACCEPTABLE

Dr. MILLER. To me, it is unacceptable for the political process to fail. To take cuts of that dimension on a mindless, across-the-board fashion would be quite harmful, I think.

Senator QUAYLE. OK, as I said, I think that's a distinct possibility, and that's why I offered this question I want to get some sort of feeling on this issue, on how bad you think what Senator Hollings sponsored, on what we all voted for, will really be. Is it really unacceptable?

Dr. MILLER. Well, if I could answer you, it is a club in the closet that forces, I think, the process to work, that forces us to get the spending level down. But it's a club that we don't want to have come out of the closet and bludgeon——

Senator QUAYLE. But what people are going to be looking at, as they vote for or against the budget resolution, is whether we might be better off under the Gramm-Rudman-Hollings sequestration, or am I going to be better off with the Domenici budget resolution—or whatever we may be voting on. And that's the predicament, and that's exactly what's going to happen around here. And that's why I'm just trying to get a feel from you on how unacceptable the red light the chairman is pointing to is—meaning the Gramm-Rudman-Hollings sequester—really is.

Chairman DOMENICI. You don't have to answer that. Time's up. Senator Hollings.

INSTILL BUDGET DISCIPLINE AND G-R-H DEAD

Senator HOLLINGS. Thank you, Mr. Chairman.

I agree with you, Dr. Miller, that the cuts in October for Gramm-Rudman-Hollings, would be unacceptable. We're in the ball park thinking in terms of 18 percent cuts in defense and 25 percent cuts in nondefense. Those have been the figures used by Dr. Penner, at CBO.

So we've created something worse than doing nothing. In other words, you call it a club in the closet. I say worse than doing nothing. And hopefully the whole intent is for the trigger never to have to trigger. And that after this year once we instill discipline you'll never have to hear of Gramm-Rudman-Hollings again which would suit this particular gentleman right away.

Right to the point, I know we are not going to take the President's budget and his $22 billion in domestic cuts. But let's try to look at it in the most reasonable light possible, Dr. Miller. I'd laid the groundwork and went down the entire list in the record. And I reverified those figures.

Eliminating the figure of the $2.5 billion, let's say, on a supplemental, you'd at least have increases of $46.5 billion. And you have the matter of $38 billion that you're going to have to come down in deficit amount from the $182 billion to the $144 billion which is an amount at $84.5 billion.

Now, if that's the target in cuts, and then I look over at the cuts, at your page 3-24, and your total amount there of all social programs, and user fees and everything else, if you get half of those, you're lucky.

I don't believe the Republican majority in the U.S. Senate would vote for over half of those. We might be able to persuade people of good will, who are all amenable to tightening their belts and everything else, to give you half of those particular cuts.

So you're going to be denied about $19 billion. Let me give you an example with respect to higher education. I had a group come in and say they'd rather have the trigger under Gramm-Rudman-Hollings than what you've got in the President's budget.

If you get $19 billion of your $38 billion there, of all the cuts, user fees, asset sales, and everything, you'll be lucky, and I think you would agree with me. If you look at the overestimation of revenues—that 4 percent growth keeps coming up—you'd jump some $73 billion in revenues, 1987 over 1986. We've never gotten to that 4 percent. If we come to the CBO, which is considered by the economists who appeared last week before the Joint Economic Committee—Greenspan and the others—as being liberal and generous, then you're going to have about a $19 billion loss there from the $73 billion. You're getting half your cuts, you're going to have to diminish that $73 billion by $19 billion. I'm looking at defense. And, Senator Grassley, we've got the figures. You have unobligated balances, right now, of $62.6 billion, and $270.6 in unexpended balances.

LUCKY TO GET LEVEL FUNDED INFLATION

Unexpended balances. Congress realizes they've got $270 billion bucks backed up in the pipeline, and we're trying to find savings in this budget to help with the deficit. In unobligated balances—money not even contracted for—we have $62.6 billion right this minute. In fact, you estimate the unexpended balances to go to $304 billion. There's no reason—when you're buying these $700 toilet seats and coffee pots and everything else—for me to give you more money to just sock away over there.

So you're going to be lucky to get what we call a level funded inflation. You use that expression on the first chart, "Funds National Defense at Compromise Level."

Compromise level. What you've done is go back to the August budget which I didn't vote for. We realized it was wrong. You agreed with me in October it was wrong. That's why we've got Gramm-Rudman-Hollings.

Then with the cut of 4.6 percent you reinstill the 4.6 percent, plus the 4-percent inflation, plus the 3 percent real growth. So you better get realistic. Instead of this $16.4 billion you and I are talking about in outlays, it better be about $8 billion.

In other words, you get to 3-, 4-percent inflation in there, and forward funded on those budget authorities in previous years, it's going to be instead of $16 billion about half of that, of $8 billion. And then on the nine increases, it's going to be difficult, because I've looked at the increase list. That's why I want you talking to the President to begin to understand it the way we understand it. He asks for more for aviation safety, drug enforcement, REA and nuclear waste disposal, income security for veterans, unemployment compensation. I can go down this list. It's going to be very, very difficult for us to deny those increases.

So if we deny a couple billion there, add all of those together, half the President's cuts, the overstated revenues by $19 billion, the defense by $8 billion—just cut that outlay figure of $16.4 billion in half, and denied increases of a couple of billion dollars—and that's not child's talk, that's talking sense, you still add up there $48 billion, and you subtract that from the $84.5 billion and you're $36 billion off. So if I can do better than that even, some $10 billion, I'm $26 billion off. That's why the distinguished chairman and I are having to think about revenues.

I've gone through the budget as fast as I can in the 5 minutes. But I'm giving a rather reasonable analysis. I'm giving you half—all your cuts, your fees, your fire sales and everything else of that kind and still coming along with all that—that's a pretty good estimate on revenues, still only $19 billion back from the $73 billion. The defense figure of increasing outlays aqain next year, some $8 billion with all of these moneys backed up. You can see that crowd that's against defense; they're going to be really after you. And the increases, if we could deny a couple of billion, maybe, you still have got $30, $35 billion gap in there, and that's why we're thinking about revenues.

BUDGET CUT OF 6 PERCENT CAN BE SUSTAINED

Dr. **Miller**. Let me respond to that by saying if you look at the increased revenues simply on the receipts side, and you look also at the offsetting receipts, both distributed and undistributed, what you have is about 30 percent of the $38 billion in savings that we need to get down to the $144 billion deficit. Only 70 percent of the cuts are programmatic reductions. So there's already increased revenue in the budget proposal.

And when you look at the cuts, and at the base for those cuts—and that's that lower section, not counting defense, Social Security or interest—we're talking about 6 percent; 6 percent. And that is not the end of the world. We can sustain a 6-percent cut in those areas, out of $400 billion plus.

Senator **Hollings**. I know, that's giving the big figure, but I took your overall figure of $38 billion. There's only $22 billion from the nondefense programs.

And I'm using your figure there. So the Congress is not all spend, spend, spend, and the President all cut, cut, cut. He hasn't cut. He has asked for more increases than he has for cuts.

That's baseline. That's where you and I start. Starting from that particular point, looking at the revenues, we could both be right and both be wrong, but I'm still looking at that $30 billion gap. I don't want revenues. I'm running for reelection. You know, I'm not a nut. I learned something from Mondale. But having sponsored this thing, I've realistically got to have at least the decency to make some sensible proposal to carry it out. If I can do it without revenues, please help me. But I still don't see it.

Chairman **Domenici**. Thank you, Senator Hollings. Senator Sasser.

CUTS IN THE PELL GRANT PROGRAM

Senator **Sasser**. Thank you, Mr. Chairman.

Dr. Miller, I want to return to the refrain that was in the message we heard last night relative to family values, and encouraging the stability and security of the American family. The student aid package contained in this budget calls for the improved targeting of loans and grants to the neediest students, and of course we want to see the neediest students get student aid.

But funding for the Pell Grant Program, which provides scholarships to low-income students has been cut by 46 percent, and students are going to find it more difficult to borrow money to pay for college, and under the proposals contained in this budget, most interest subsidies on student loans are going to be eliminated.

Now, I am advised that a freshman in college, for example, who borrows $2,500 in college loans would end up paying an additional $1,100 back as a consequence of the proposals presented here.

It appears to me that while we're talking about family values, and of course education is one of the most cherished family values, we in essence are diminishing the opportunity of a great number of students in this country to get a college education. And how, indeed, do we hope to break the dependency cycle if students in the lower economic brackets cannot afford a college education.

I see an inconsistency here between what was espoused last evening and the budget proposal that we have before us today.

How do you justify, or how would you rationalize these cuts in student aid in the Pell Grant Program, for example?

STUDENT AID TARGETED TO NEED

Dr. MILLER. Well, let me say again we are going to target the grants on those students that need it the most. We're also going to target the support on those students who actually go to school—for example, we're going to require that before a student receives such a grant, they have a high school diploma and some evidence that they're going to college.

Third, just bear in mind that this whole area has grown by explosive dimensions in the last several years. When we went to college, there weren't anything like these kinds of programs.

Finally, I would point out that a rising economy, which I think would be the result of our getting the deficit under control, and avoiding an increase in taxes, and avoiding these other things, is going to be very helpful to students who want to go to college. And not all students who get such educational support live only on the educational support; they live on outside income as well, as I did when I went to school. I happen not to have borrowed any Federal moneys. And I worked to pay my way through college.

It's not that we're being antifamily or antieducation or anything like that, but in a time in which we have to come to grips with fiscal realities, we need to look at those areas where the programs could be retargeted and provide more bang for the taxpayers' buck.

EDUCATION CUTS COULD HURT MIDDLE INCOME

Senator SASSER. Well, I'm concerned, Dr. Miller, because we've seen a virtual explosion in the expense of a college education in recent years. And I fear that many middle-income students are going to be effectively precluded from going to college with these cuts that are being proposed, and coming at a time when I fear also that our economy is becoming less competitive in the international field, and we hear time and time again these assertions, which are accurate, that other countries are educating their students better. Time and time again we hear statements being made that Japan, a country half the population of the United States, turns out more engineers per year than we do. And given this scenario, I find it—I must say—pennywise and pound foolish to be cutting back on some of these educational programs at this time.

USER FEES ON HOME MORTGAGES

Now, one other item I'd like to explore, certainly one of the goals of every American family is to own their own home. And this budget contains several proposals dealing with the imposition of user fees on Government-sponsored enterprises.

It's interesting that we don't talk about tax increases anymore. They're revenue enhancers, or user fees, or something like that.

These Government-sponsored enterprises have been designed to encourage certain sectors of our economy, but most importantly to allow the American family the dream of owning their own home.

We've decided over the years that this is not only good economic policy, but good and sound social policy.

Now, the Mortgage Bankers Association projects that these proposals to impose user fees on FHA mortgages would double the downpayment on FHA mortgages, and would make one-third of all the potential FHA borrowers ineligible for an FHA mortgage, and currently on the average VA loan, these user fees would in effect double the fees that the veteran would pay, double it from $662 on the average to $1,325.

Now, here again I think we have another example of where this budget falls short in the area of seeking to make more secure and more stable the American family in two basic areas: One, in housing; the other, in my judgment, in education.

And it appears to me that there are other areas, perhaps, in which our cuts could be better made. And a user fee by any other name I would call a tax increase.

Dr. MILLER. Well, Senator, if I could respond, a user fee is I think very different from a tax increase, or a general tax such as you pay on your own personal income. I think a general tax is very different from paying a user charge, for example, a ticket tax on aircraft for the use of the airport-airway system.

Let me say on the FHA thing, this is a good example of targeting. I'm not sure why people generally should be subsidizing everyone's purchase of a home. Obviously most homes are purchased without FHA financing. Second, the proposal is to limit, as I recollect, to limit those eligible for FHA loans to those earning incomes less than $40,000 a year.

We have many people whose incomes are above $40,000 a year who obtain FHA loans subsidized by the general taxpayer.

Also, as you know, since you can borrow essentially against the payment for the service, you can buy a lot of homes with no money down, so if you doubled the downpayment it might not be very much.

I would just have to see the study. It's interesting that they've come out with a study without first seeing what the President's proposal really is. But I would welcome an opportunity to review their study to see whether we would agree with their assessment.

HEALTH PROGRAM CUTS AFFECT SENIOR CITIZENS

Senator SASSER. My time has expired. Thank you.

Senator HART. Mr. Miller, let's pretend for a moment that you're in a room of senior citizens, none of whom has an independent source of income, and one of them asked you this question: Why should my health benefits be cut so that my tax dollars can be given to Jonas Savimbi?

Dr. MILLER. Well, let me answer without getting into the issue of Mr. Savimbi, and foreign policy, which I probably better not discuss in any detail, since I do not know what's classified and what isn't. Let me say, first of all, I would say to them, "your Social Security will not be cut." The President has indicated that very specifically.

Senator HART. But a number of Federal health programs that impact senior citizens will be cut.

Dr. MILLER. The programs will be cut, but out effort is to target these cuts in such a way that the services provided to those consumers will not be cut.

Senator HART. All right. The same person asked this question: Why are those health programs being cut to finance the military buildup instead of increasing taxes on wealthy individuals and corporations who are paying no taxes?

Dr. MILLER. I would say there are a number of ways to finance anything. What is the equlibrium or appropriate level of taxes for any sector of the economy? People generally have perceived our tax system to be very complicated, very unfair, with a lot of loopholes. The President is trying to obtain tax reform on a very separate track. He is trying to make the system fairer, so I would say that——

Senator HART. He's not raising taxes on large corporations or wealth individuals.

PEOPLE PAY TAXES, NOT CORPORATIONS

Dr. MILLER. Well, I think if you look at what the President's tax package asks for, you will see a lot of closing of loopholes that allow certain corporations to escape.

But beyond that point, altogether, is that corporations don't pay taxes. People pay taxes. Who owns the corporations? You know, economists have debated for many years whether the incidence of the tax is on the owners of the corporation, on the workers employed by the corporation, or whether it's paid by the consumers of the products and services produced by the corporation.

Senator HART. Mr. Miller, we've settled that issue. We have a corporate tax in this country. And there are a lot of corporations that don't pay it. And I think it's a sufficient question for a senior citizen to ask, why are my health programs being cut, to finance the military build up when those corporations are not paying taxes.

FAMILY INCOME HAS DECLINED

In your opening statement, you were rather complimentary of the administration's economic achievements, including one central assertion that is flatly wrong, that family income is up, an all-time high, you say. Average family income has declined over the past decade by 14 percent. Half that decade has been under this administration.

Let me read you eight or nine facts and see if you dispute any of them; 33.7 million people live below the poverty line. This is the highest rate since 1966. Since 1980 for the first time in the postwar period, the distribution of income has worsened. In 1984, the poorest 40 percent of all families got 15.7 percent of all income, the lowest share on record, while the share of the top fifth rose to nearly 43 percent, the highest share since 1948.

The Reagan administration argued in 1981 that it's programs would create 12 million new jobs by 1986; 9 million have been created, leaving a shortfall of 3 million against that claim.

Our savings and investment record of the 1980's has been the poorest in some 50 years. The tax cut of 1981 did not budget the net long run private savings rate of about 8 to 9 percent of GNP. Net investment by Americans is at its lowest ebb since the 1930's. Investment in American industrial capital has been steadily declining as a share of gross national product.

Net interest on the public has zoomed from $43 billion in 1980—public debt—$43 billion in 1980 to a projected $138 billion in 1986, and that the present rate of increase would reach over $200 billion by 1991.

Do you quarrel with any of those facts?

Dr. MILLER. I would quarrel with some of them. I would like to respond to you in writing, though, on them if I could.

Senator HART. All right. They're taken from testimony by Walter Heller before the House Committee on Banking and Finance, October 17, 1985.

But they are not included in your assessment of what the state of the economy is in your statement. Do you think they should be?

U.S. SAVINGS RATE

Dr. MILLER. Well, no. Like I said, I would be glad to respond to each of those in writing. As you point out, the savings rate that we experience, as a society, is too low, and I think we have experienced a low savings rate for some time now.

The savings rate is Japan is much higher. I was talking with a couple of individuals who work with the Japanese equivalent of OMB a few weeks ago, and we were trying to determine whether the higher savings rate in Japan was cultural, or whether it was simply responding to incentives, and I do not think we drew any hard and fast conclusion; probably some of both.

But I agree, that this is an area which we need to work on. It has to do with tax policy. It has to do with the incentives people have to invest; how much of their earnings they can keep after they make such sacrifices.

But it is the kind of thing that I do not think is easily addressed in a budget document.

SUPPORT FOR BUDGET URGED

Senator HART. Mr. Chairman, just an observation. We received the budget this morning—I did—received my copy of the budget at 7:30. It is very difficult to, in 1 day, to ask cogent questions. It was curious to me that yesterday, before the budget arrived, I received a mailing from an organization called Citizens For America, which contained a summary of the President's 1987 budget proposal, and urged my support for it.

It seems we contacted this organization, and it seems that they received a briefing on the budget over a month ago. I think you ought to put Congress first.

Dr. MILLER. First of all, I have been giving a number of briefings for Members of Congress: to the bipartisan leadership, and at meetings at the White House on a number of occasions. I did not give Citizens For America the details that I understand that they have.

Senator HART. Where did they get them?

Dr. MILLER. A number of other organizations, news organizations, I understand, have quite a number of details I also did not make available.

Senator HART. Where did they get their information?

Dr. MILLER. I do not know.

Senator HART. You do not know?

Dr. MILLER. No; I do not.

Chairman DOMENICI. Senator, could I just ask this: Will you answer the remaining questions that he asked about, for us, and can you do that maybe within the next 8 or 9 days, 10 days?

Dr. MILLER. Surely. I will try very hard.

Chairman DOMENICI. We will be on recess next week.

Dr. MILLER. Yes; I know you will.

Chairman DOMENICI. So that we will not have you up here for a while again.

Dr. MILLER. Right.

Chairman DOMENICI. You will be free for a few days. We would appreciate having a response.

[The following was subsequently submitted for the record by OMB:]

POVERTY

Official poverty statistics for 1984, the latest information available, show that 33.7 million people were poor. In that year, 1.6 million persons were lifted out of poverty—the largest reduction in the number of poor persons since 1968.

In the no-growth, high-inflation years of 1979-1980, the poverty population increased by 4.8 million persons. Poverty continued to rise during the 1981-1982 recession, which was a product of the stagflation of the late 1970s. In 1983, as the Administration's policies began to pay off and the recovery took hold, the poverty rate stalled at 15.2 percent; in 1984 it fell to 14.4 percent, the largest reduction in the poverty rate since 1973. Virtually all demographic groups shared in the gains—blacks, children, and persons in female-headed households. Elderly poverty declined for the fourth year in a row is now at an all-time low.

The downward trend in the percent of aggregate income shared by the poorest 40 percent of all families began in 1969. In 1983 and 1984, this downward trend was moderated. The upward trend in the percent of all income shared by the highest fifth of all families began in 1968. This trend was also moderated in 1983 and 1984.

EMPLOYMENT GAINS

We are not aware of a 1981 administration projection of 12 million new jobs by 1986. What our 1981 economic assumptions did show was an unemployment rate of 5.7% by the first quarter of 1986. In fact, the unemployment rate for January was 6.7%, so we were a percentage point too optimistic. That translates into about 1.2 million fewer jobs than the 1981 projection—a serious error for a short-term forecast, but quite modest for a 5-year projection.

INVESTMENT

Over the 5-year period 1981-1985, business fixed investment averaged 11.5% of GNP—higher than any previous 5-year span in the post war period. The GNP share of capital investment has been rising, not declining. The ratio of investment to GNP in 1985 was the third highest recorded in 40 postwar years; the highest ratio occurred in 1981, the year the Reagan tax cuts were enacted.

NET INTEREST

Net interest was $52.5 billion in 1980, not $43 billion, and the current estimate for 1986 is $142.7 billion rather than $138 billion. The projection for 1991 is $116 billion, assuming enactment of the administration's budget proposals, which achieve budget balance by that year.

Chairman **Domenici**. Senator Hart, if you have a couple more questions, go ahead.

PRIVATIZATION OF GOVERNMENT ASSETS

Senator **Hart**. Well, just this observation, since I did not make an opening statement. This privatization issue, we ought to think about very hard, because we are starting down a path that I think Senator Moynihan and I have been predicting for a long time, part of an overall plan or a scheme.

We are being asked, to use the President's family analogy, to "sell off the family heirlooms," and if there is one thng we have that we pass on to our children, they are the public assets of this Nation.

Now, if we have arrived at these deficits, which you sort of, in your statement, toss off as an irrelevant side effect of something, unrelated to all these benefits that we have received, the fact of the matter is, the upside of the economy has been financed by debt.

We have borrowed money from our children, and from foreign countries to finance these achievements, and now we are being asked to sell off the public assets of this nation, the treasures of this nation.

You start with the Bonneville Power Administration, and pretty soon you are going to be where Senator Goldwater was on TVA in 1964, and you are not very far, then, from the oil and gas resources, and reserves, and the timber, the mining reserves of this country, which are the legacy that we leave to our children. I think we are starting down a very dangerous slope.

DEFICITS WORST LEGACY FOR POSTERITY

Dr. **Miller**. Could I just respond to that? I think that continuing with deficit finance, as I think you are hinting, Senator Hart, is probably the worse legacy that we could leave to our children. We really do borrow on their backs because, to some extent, there is a fiscal illusion about the nature of the burden of the debt.

And second, I would suggest that the kind of privatization that we are talking about is not one in which we are selling the treasures of the country. We do not propose selling any public lands.

We propose selling two commercial type of operations: First, the Bonneville Power Administration. There has been some interest in the region for the transfer of those assets to a local region or to a private purchaser. Also we are looking at Teapot Dome and Elk Hills.

I do not believe there is any reason, in terms of our security, or in terms of the future, why we should hang on to those assets.

Senator **Hart**. How is Bonneville different from TVA?

Dr. **Miller**. For one thing, TVA is much broader in its activities then is Bonneville Power.

Senator **Hart**. But no difference in kind?

Dr. **Miller**. No; it is different in kind.

Chairman **Domenici**. Thank you, Senator.

Senator Lautenberg.

BUDGET CUTS IRS

Senator **Lautenberg**. Thanks, Mr. Chairman. Dr. Miller, I want to discuss revenues a little bit. I recognize that there is proposed an increase in IRS funding and staffing, and enforcement, and I think that is long overdue.

I do think, however, it is one of the more absurd parts of Gramm-Rudman, that as part of across-the-board cuts IRS had been cut $140 million. While the administration's initiative is certainly welcome, it is in my view inadequate.

You project taking in an extra $600 million as a result of expanding the base, but that is not much compared to a revenue gap that is said by many to be about $90 billion.

Now you project an increase in the number of returns to be examined, of roughly 200,000 over last year's level. Am I making sense?

Dr. **Miller**. Oh, you are making sense. I do not recall the figures.

Senator **Lautenberg**. OK. The number of returns——

Dr. **Miller**. Woe be it to me to suggest a Senator is not making sense.

INITIATE FEDERAL TAX AMNESTY PROGRAM

Senator **Lautenberg**. OK. But the number of returns are expected to rise by over 10 million. Total returns, close to 190 million. All in all, this initiative is going to have us audit about 6 returns for every 10,000 filed. Is that going to strike fear in the heart of the taxpayer? Now, I believe we ought to take a look at what some States have been doing, and initiate a Federal tax amnesty program.

Why shouldn't we offer individuals and corporations a deal: Come forward and pay your tax, plus the interest, and, forget about some of the penalities, both civil and criminal?

Now I have heard that a Federal tax amnesty program could raise $7 billion or more in revenues in the 1st year.

And then, with those folks back on the tax rolls, we would be able to gain added revenues in the out-years as well.

We could apply some of that revenue to improving enforcement and compliance, and increasing the examination group by more than 6 per 10,000.

Do you have any reason to believe that a Federal tax amnesty program would not raise a significant amount of money?

Dr. **Miller**. Senator, that is an intriguing idea. I have not given it any thought.

POLL SHOWS AMERICANS CHEAT ON TAXES

Senator **Lautenberg**. Well, let me encourage the intrigue a little bit, by telling you that in a Lou Harris poll recently conducted, 18 percent of Americans said they, or someone close to them cheat on their taxes.

Chairman **Domenici**. How many, Senator?

Senator **Lautenberg**. Eighteen percent, and that is those who are willing, even in the privacy of an anonymous poll, to say it. It is a lot, and we have got a gap of close to a hundred billion, and that is a lot.

Now perhaps we are looking to get this increased revenue with a stick about the size of a toothpick. And so I would like to urge you to examine, the idea of amnesty more closely. We would first try a carrot, say, "Come on in," and then, bang, I would give an increase in punishment for future evasion.

Dr. **MILLER**. Well, let me raise a possibility, Senator. The administration occasionally studies the effects of adding more IRS collection efforts. It may be that it would be possible to fold your suggestion of a liberal amnesty program, into a future study.

Senator **LAUTENBERG**. I would like to press forward, because one of the things that all of us have agreed on, no matter what side of the GRH program we are on, is that we would like to solve the problem without the Draconian cuts, and as I said here, when you were here last time, I am glad that I did not vote to put the budget decisions on automatic pilot.

But one way to get off of that trajectory is to find other ways to finance these programs, those that we think are essential, without increasing taxes.

Dr. **MILLER**. Senator, could we say for anybody who may be watching—I am thinking of something that you would probably concur in—and that is, anybody who does owe the Federal Government any income tax, we would both encourage them to pay those taxes.

Senator **LAUTENBERG**. Amen.

But, an amnesty would increase the prospects for collecting those moneys owed. I assume the President would not consider a tax amnesty a new tax or a user fee.

Dr. **MILLER**. No; I would not call them tax increases, or user fees.

OIL IMPORT FEE AS PART OF TAX REFORM

Senator **LAUTENBERG**. Right. The "Post" reports that the President is saying that he would consider the oil import fee as a part of tax reform. And there are those who are concerned by the President's remark only because they would like to see the money from an oil import fee used for deficit reduction. I am all for deficit reduction, but I am concerned for another reason. I think an import fee is terrible. It is bad tax reform and it is bad as deficit reduction.

And given the talk about the fee, some noted economists very recently have spoken out saying that it hurts consumers, that it is inflationary, slows economic growth, injures trade, and undermines the effect of the progress we have made on exchange rates there are a whole series of effects.

Certainly it hurts the Northeast, and my State particularly because so much of our dependence is on imported oil. I wondered whether you had a reaction to these views of an oil import fee.

Dr. **MILLER**. Well, let me, again, let me clarify. The President has said that he would not put it off the table. He would not reject entirely the notion of looking at an oil import fee as a means of making the tax reform package revenue-neutral.

On the other hand, as a means of trying to address the deficit issue, the President has indicated, privately and publicly, his opposition to an oil import fee.

I think the effects of an oil import fee would be to slow our rate of economic growth from what it would have been otherwise, and as you pointed out, it does have differential effects by the sector of the country. One thing that I find a little bit curious is the notion that just because the price of something happens to be falling, it is a good candidate for a tax. If suddenly there was a superabundant harvest of grapes, and grapes plummeted in price at the local grocery store, I do not think there would be a clamor for putting a tax on them simply because people then would not notice the tax because the price of grapes would not rise.

OIL TAX WOULD NOT BE DISMISSED OUT OF HAND

I think oil of course is much, much more important because it so permeates our economy in terms of both consumption and production.

If you accepted the notion you had to raise taxes, I think there are probably better ways of doing it, but in a spirit of cooperating with those in Congress who are most involved in rewriting the tax law, and involved in tax reform, the President said that he would not dismiss it out of hand.

Senator **Lautenberg**. Yes; Well, even those of us who are not involved in the rewrite certainly are deeply interested in what takes place. Many of us feel that an import fee should not be imposed.

You know, the President, last night, talked about trade protection, and as I said to you, an oil import fee would be very harmful in my State, in my region, because it not only affects the direct consumer of products but those who work in industries that are dependent on imported oil.

Now the President said that he is going to oppose legislation, that "in reality pits one American worker against another, one industry against another, one community against another, and that raises prices for us all."

Now I think that hits the nail on the head, when you talk about an import fee. Thanks, Dr. Miller. Thanks, Mr. Chairman.

Chairman **Domenici**. Thanks very much, Senator. Senator Moynihan.

Senator **Moynihan**. Dr. Miller has been here a long time. You have to leave at 5 o'clock?

Dr. **Miller**. That would be my preference. I have an appointment.

FAMILY INCOME PEAKED IN 1973

Senator **Moynihan**. Would it make you feel any better if I told you it was 4:50 p.m., and I will be less than 5 minutes? It is a question of fact. In your opening statement you say that "family income is at an all-time high." I do not think so. I think that, to the contrary, we have a median family income now below what it was in 1973. It peaked in 1973, and has not recovered. I do not think there has been a period in American history equal to this.

Dr. MILLER. Senator Moynihan, I am reluctant to disagree with you because I well know of your scholarly pursuits in this area. This was checked by my associates and I will check——

Senator MOYNIHAN. You have got an aide who is taking notes right at this very moment behind you.

Dr. MILLER. I will get back to you.

OVER A DECADE OF ESSENTIALLY FLAT FAMILY INCOME

Senator MOYNIHAN. That is a fact. There was no period in postwar American history like this. Before 1973, we never went 3 years without family income reaching a new peak. It always broke a record within a 3-year period, and we have had now over a decade of essentially flat income.

I do not think in American history that we have had that experience.

Dr. MILLER. We have had some change in composition of the family.

Senator MOYNIHAN. Well, and with that extra female worker, it is still a family income; I mean, it supplements it. I do not know that there is a larger, or a less understood phenomenon taking place in the country and it has been going since 1973.

Dr. MILLER. If I am wrong, I shall correct the record.

[The following was subsequently supplied for the record by OMB:]

HOUSEHOLD INCOME

Between 1970 and 1985, disposable (i.e., after-tax) personal income rose 290 percent in current dollars. We do not have this figure on a per-family basis, but on a per-household basis, it is an 186 percent increase. Discounted for inflation, real per-household disposable personal income rose 10 percent. Of this real improvement, 60 percent occurred in the four years 1981-1985, an annual rate of improvement four times as rapid as that over the previous 11 years 1970-1981.

While we do not have information on family disposable income, we do have data on family current money income, i.e., before-tax money income as defined and collected by the Census. This measure shows that median real family income peaked in 1973. Between 1981 and 1984, the latest year for which data are available, median real family income increased 3.4 percent.

Senator MOYNIHAN. Could I just ask you, once again—not in any accusatory way—but we did see that deficit drop from—well, upward-bound of $200 billion on January 22, to $182 billion on February 5, and as you know, the CBO has already put out different projections.

How do we deal with this, sir? The President last night said that the budget process is broke, and one of the places where it is broke—on your watch—is the divergency of estimates.

Dr. MILLER. Right.

Senator MOYNIHAN. Of revenue. How much we are going to save from giving IRS auditors personal computers? What is the GNP growth going to be? What will the interest rate be? Those are serious questions whose answers are subject to forecasting errors.

I mean, I have made only one useful scholarly observation about this whole process: That when the Democrats were in office, we reached zero deficit in 3 fiscal years.

The principle changed with Republicans; it is now 5 fiscal years before you get to zero deficit.

Dr. MILLER. Right.

Senator MOYNIHAN. And if we come back in again, why, we will be back to 3 fiscal years, and that is a case we could make, and we will no doubt do.

Under the Democrats you get a balanced budget in 3 years.

Dr. MILLER. Right.

Senator MOYNIHAN. But I mean, do you calculate that there will be any loss of revenues from the reduction in IRS auditors that was contemplated?

Dr. MILLER. Because of the sequester?

SUPPLEMENTAL FOR IRS

Senator MOYNIHAN. Yes; I mean, if you cut Internal Revenue auditors, you lose income, do you not?

Dr. MILLER. Right. Ceteris paribus. There would be a reduction in total collections. We have going on a separate track, quite aside from Gramm-Rudman, a supplemental for IRS that has gone to Congress.

Senator MOYNIHAN. Which would increase funds for the IRS?

Dr. MILLER. Yes.

TAX COLLECTING SYSTEM IN TROUBLE

Senator MOYNIHAN. Which would increase. Well, to the point that Senator Lautenberg made: I am on the Finance Committee, and we really are beginning to worry about just the tax-collecting system, much less the tax system.

Dr. MILLER. Yes; Well, you know, it is a very interesting tradeoff because there is an underground economy that we miss; there are people who do avoid paying taxes, and might be brought under the kind of system that Senator Lautenberg talked about. I think it is something we need to look at.

At the same time we have found that by turning to the IRS for certain collection activities, whether it is a guaranteed student loan that has not been repaid, or something like that, it is very effective in generating loan repayments, but at the same time, the IRS is very concerned that it lowers respect for the collections system.

Senator MOYNIHAN. Well, they are not wrong. I mean, they are not a collection agency. They are a revenue service. And I end on this thought: We are the only industrial nation in the world, the only nation in the world where taxpayers assess their own income, their own taxes. I mean, in the United Kingdom they are all loyal subjects to the crown, but the crown sure as hell does not trust them and decide how much income tax they owe, you know.

Chairman DOMENICI. And in France they negotiate.

Senator MOYNIHAN. In France they negotiate. Thank you, Dr. Miller. It has been a long afternoon.

Dr. MILLER. Thank you, Sir.

Chairman DOMENICI. Let me thank the Senator for being brief and I appreciate it because Senator Exon has been waiting a long time. We are not going to get you out at 5 o'clock but we will not be too late.

Dr. MILLER. Fine.

Senator EXON. It will be pretty close. I will try and be brief.

Chairman DOMENICI. I have not asked any questions.

INTEREST RATE ON THE NATIONAL DEBT

Senator EXON. What was the interest rate on the national debt, or what interest rate assumptions were made in your projections, Dr. Miller?

Dr. MILLER. Senator——

Senator EXON. Just roughly, I mean. Six percent? Seven percent? Eight percent?

Dr. MILLER. It is 6.5 percent for 1987.

Senator EXON. How much?

Dr. MILLER. The interest rate on 91-day T bills is 6.5 percent.

Senator EXON. All right. Go ahead.

Dr. MILLER. And 5.6 percent for 1988; 4.8 for 1989; 4.3 for 1990; and 4.0 for 1991.

Senator EXON. Are those not awfully optimistic?

Dr. MILLER. Well, they do come down, but again, they are a reflection of recent experience—although we have a slight blip in 1987 in the interest rate, because we have had a rather permissive monetary policy in the past. As you probably know, the interest rate at one point in time is very much a function of monetary policy——

Senator EXON. All right.

Dr. MILLER [continuing]. Lagged by 1 year or so. But we anticipate as the rate of inflation continues to fall, and we do something about meeting the Gramm-Rudman deficit targets which narrows the real rate of interest, the nominal rate of interest will fall over time.

Senator EXON. But are not those interest rates that you just quoted, at or below the interest rates that were in effect before we started this tremendous upward climb in the total government deficits?

Dr. MILLER. They are optimistic by recent history, even before the very substantial deficits that we have run in the last several years, but they are not particularly high by historical standards, going back a couple of decades.

REDUCING ASSISTANCE TO RURAL AREAS

Senator EXON. Dr. Miller, this next question has to do with choices that have to be made, and I do not necessarily fault you for that. I am just pointing out that 24 percent of the reduction for 1986 and 1987 comes out of the Ag budget, the commodities section primarily.

That reduction represents over 16 percent of the total deficit reduction for 1987, although agriculture accounts for less than 3 percent of the total budget.

In addition, the rural sector of America is getting hit with many other places in the budget. It seems to me that the Reagan administration is continuing to dramatically reduce the government assistance going into rural America, as opposed to other parts of the budget.

Is that a false assumption on my part?

FARM BILL LARGEST IN HISTORY

Dr. MILLER. Senator Exon, first of all, the farm bill which the President signed is the largest farm bill ever in the Nation's history for supporting the agricultural community.

Second, nothing in this budget is meant to undo the provisions of the farm bill. All of the commodities were put quite aside from our efforts on the budget. What you——

Senator EXON. But it does not undo the farm bill?

Dr. MILLER. No; it does not. A major portion of what you see in terms of a decline from 1986 to 1987 reflects a provision in the farm bill which essentially shifts deficiency payments into 1986 from 1987.

That is pursuant to what was dictated in the farm bill itself.

AGRICULTURE TAKING BIG BUDGET HIT

Senator EXON. Well, when you take the hit, or reduction that agriculture has taken over the 5-year period, they are receiving considerably more of the hit, or reduction, than would be justified, it seems to me, under less than 3 percent of the total budget?

Dr. MILLER. No, sir; I would just argue quite the contrary. If you look at the remarkable increase in total outlays to agriculture under the new farm bill, you would say that even though agriculture——

Senator EXON. Well, what you are saying is since the new farm bill went up so much, it has to come down further, is that right?

Dr. MILLER. No; the farm bill essentially took some deficiency payments out of 1987 and put them into 1986. The farm bill dictated that. That is the reason it appears that there is a $4 billion, decline from 1986 to 1987. It is simply our carrying out the law incorporated in the farm bill itself.

TRADE DEFICIT

Senator EXON. Let me ask you about the trade deficit. Was the trade deficit, which is an important part of our overall economics—was the trade deficit that is now running in the area of $150 billion a year—what were the figures on that in this?

Dr. MILLER. Oh, there is nothing on the trade deficits per se in our budget. Our budget is geared toward a recognition of the need for other countries to appreciate their currencies, but that is not something that is directly a function of the budget.

Senator EXON. So in other words, then, is it fair to say that this budget is predicated on the trade deficit remaining the same, which affects unemployment and all that?

EXPECT OTHER COUNTRIES TO APPRECIATE CURRENCIES

Dr. MILLER. No; we anticipate that the trade deficit will narrow because we anticipate some successes in efforts by other governments to apprecate their currencies by their economies growing stronger, but there is nothing specific in this budget meant to appreciate foreign currencies.

DIFFERENCE BETWEEN FEES AND TAXES

Senator **Exon**. Let me ask one last question which has been asked in different forms before. What can you tell us, without revealing any confidences, and personal conversations you have had with the President, with regard to the President's stand on some kind of enhanced revenues? The President made quite a speech last night and one of the best I have ever heard him give, and he was warning that he as not going to allow a tax on families.

I do not know of anyone up here considering or suggesting, either in the House or the Senate, a tax on families. It was all other kinds of revenue.

Was the President making the point, when he pointed at the family last night, and said, "Wait just a minute, I'm not going to let that happen"—to paraphrase him—was he saying that he might, and was softening his attitude toward some other kind of oil import fees as opposed to taxes? Is the difference between fees and taxes, is that important to the President?

Dr. **Miller**. No, sir; I do not think that is what he meant. I think, at that point, he was juxtaposing whether you should tighten the Federal budget or tighten the family budget, and a tax increase would be tightening the family budget as opposed to tightening the Federal budget.

And let me say beyond that, without again disclosing any details of my discussions with the President: I will just say he does not say anything privately that is inconsistent with what he says publicly on this issue.

OPPOSITION TO INCOME TAX SURCHARGE AND OIL IMPORT TAX

Senator **Exon**. Well, he is against any kind of increased revenue, whether it is in the form of fees, taxes, licenses, or anything else?

Dr. **Miller**. No; I do not say that. There are a number of increases in user charges in this budget. There are a number of sales of assets in this budget, all of which he has approved.

But I think if there were gradations of his opposition, he might be particularly opposed to, say, an income tax surcharge.

Senator **Exon**. I think he made that very clear and that is what I am trying to ask you about. Is he adamantly opposed, in your opinion, to an oil import tax or fee?

Dr. **Miller**. Yes, he is adamantly opposed to an oil import fee as a means of increasing net revenue because he does not view that in the same way he would view a user fee for certain kinds of government services.

Senator **Exon**. Was the story in the Wasington Post this morning accurate, when it indicated that the President might accept an oil import fee for the purposes of making up revenue in the tax bill, but would be against an oil import fee from the standpoint of using it to reduce the deficit?

Dr. **Miller**. I did not read the story, but consistent with my colloquy with Senator Lautenberg, I think that accurately reflects his judgment.

Senator **Moynihan**. That he would not dismiss it out of hand?

Dr. MILLER. He would not dismiss it out of hand. He would be willing to consider exchanging types of taxes, but not increasing total taxes.

Senator EXON. Which means that that story was generally accurate, though?

Dr. MILLER. Yes; well, again, I have not read the story but from your characterization, I would say it is generally accurate.

Senator EXON. Thank you, Dr. Miller. Thank you, Mr. Chairman.

TAX REFORM TAX INCREASES OF $140 BILLION

Senator HOLLINGS. I have just one question on that score. He does recommend tax reform. And in tax reform in order to get up the kitty to lower the brackets, Dr. Miller, he raises a kitty of tax increases of $140 billion. Don't just nod, because I have to get that in the record. Let's say the witness gave a good, affirmative, friendly blink.

You see, you've got Bradley-Gephardt, the Kemp-Kasten, and "Make My Day" President Reagan. All three groups get up a kitty of $140 billion in revenues. There's no shortage of revenues in this town. Tax increases. It's just what you use it for.

It happens to be a question of priorities. We're not opposed to reform, but our priority should be getting down this devastating deficit. And the President agrees to the devastation by signing into law, if nothing happens, an untenable situation: namely, the 18-percent cut of defense and 25 of the other.

So the President agrees and recommends up here in tax reform tax increases of $140 billion.

Dr. MILLER. Well, that is in exchange for a tax decrease.

Senator HOLLINGS. But that is a fact. That's increases so he can lower the other.

So you've got tax increases on the table up here of $140 billion that we all know about.

Thank you very much.

Chairman DOMENICI. Let me say that it's almost 10 after, and I know that you have to leave, but I am going to ask that we keep this record open till the end of the week. We have the Secretary of Defense and another major witness, and we will ask that anyone that has written questions can submit them to you for response at your earliest convenience. Hopefully within a week to 10 days.

In terms of this defense number, I do want to say to you it appears to me that there are really three reasons, very, very significant reasons that you come before us with a budget at this stage that is at least plausible, as I said in my remarks, and that maybe if I were all alone I could accept it.

I think one reason is, as compared with the last 2 years, that huge block that you put on the chart representing the reduction in defense requests by the President through you and your predecessor in 1986 and 1985. That's a huge amount of money.

And I wonder if in your charts and your remarks whether you reduced those numbers to annual outlay expectations, or merely budget authority.

Dr. MILLER. All is in the form of budget authority.

Chairman DOMENICI. Could you, even though there would be argument whether you or CBO was right on outlays, supply for the record the outlays that would have been attendant each of those years for us? For 1985, and carry it out in the 1986? It's a huge amount of money and it makes your job and ours somewhat different.

Dr. MILLER. Yes.

[The following was subsequently submitted for the record by OMB:]

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Question: Provide for the record the outlay reductions associated with the reductions for defense requests by the President for the 1985 and 1986 Budgets.

DEPARTMENT OF DEFENSE BUDGET LEVELS: OUTLAYS
(dollars in billions)

	1985	1986	1987	1988	1989	1990	1991	Total
February 1984 (FY 1985) Budget.......	264.4	301.8	339.2	369.8	398.8	--	--	--
Rose Garden (FY 1985)................	258.6	286.2	321.5	358.8	393.8	--	--	--
Change from FY 1985 Budget......	-5.8	-15.6	-17.7	-11.0	-5.0	--	--	-55.1
February 1985 (FY 1986) Budget with 1985 enacted......................	244.1	277.5	312.3	348.6	382.3	418.3	--	--
Change from Rose Garden..........	-14.5	-8.7	-9.2	-10.2	-11.5	--	--	-54.1
FY 1986 Budget Resolution...........		259.4	276.7	295.0	319.5	344.0	369.0	--
Change from Feb. 1985 Budget....		-18.1	-35.6	-53.6	-52.8	-74.3	--	-236.6
February 1986 (FY 1987) Budget......		258.4	274.3	290.7	313.3	335.5	356.6	--
Change from Budget Resolution...		-1.0	-2.4	-4.3	-6.2	-8.5	-12.4	-34.8

DEPARTMENT OF DEFENSE BUDGET LEVELS: BUDGET AUTHORITY

(dollars in billions)

	1985	1986	1987	1988	1989	1990	1991	Total
February 1984 (FY 1985) Budget.......	305.0	349.6	379.2	411.5	446.1	--	--	--
Rose Garden (FY 1985)...............	291.1	324.8	362.6	411.5	446.1	--	--	--
Change from FY 1985 Budget......	-13.9	-24.8	-16.6	--	--	--	--	-55.3
February 1985 (FY 1986) Budget with 1985 enacted......................	283.1	313.7	354.0	401.6	438.8	477.7	--	--
Change from Rose Garden.........	-8.0	-11.1	-8.6	-9.9	-7.3	--	--	-44.9
FY 1986 Budget Resolution...........		294.3	314.7	337.5	361.5	386.8	412.6	--
Change from Feb. 1985 Budget....		-19.4	-39.3	-64.1	-77.3	-90.9	--	-291.0
February 1986 (FY 1987) Budget......		278.4*	311.6	332.4	353.5	374.7	395.5	--
Change from Budget Resolution...		-15.9	-3.1	-5.1	-8.0	-12.1	-17.1	-45.4

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* Appropriated level is $289.5 billion. The $278.4 billion is the post Gramm-Rudman-Hollings sequester level. The 1986 Continuing Resolution provides that $6.3 billion of unobligated 1982-85 funds are to be available. to cover certain 1986 costs including the October 1 military pay raise.

Chairman DOMENICI. I hope in the process of going through that defense number that you have become familiar with this information. I'll ask a question now and ask that you submit an answer later.

From the 1985 request to the request that you now make to us with reference to defense, could you supply for the record what you, as OMB Director, have ascertained are the differences, programmatically, in the Defense Department?

What have they given up? What do they not get? What changes in policy that we understand are now in effect in this budget versus the 1985 which would have cost us $290 billion in budget authority more, as I understand it.

I think it would be very interesting if we would have that.

[The following was subsequently submitted for the record by OMB:]

PROGRAMMATIC CONSEQUENCES OF BUDGET REDUCTIONS

We are working with the Department of Defense to assess the programmatic consequences of these budget reductions and will provide you the joint analysis.

Chairman DOMENICI. And we'll ask the Secretary of Defense that also, clearly.

With reference to current services, I have asked you a question and you have been very forthright. You have used current services for all programs except defense, as the level postsequestration, which you're assuming on March 1 will be the appropriated level. And the actual level for nonappropriated accounts that's in law that day.

Dr. MILLER. Right.

Chairman DOMENICI. On defense, you chose another. And we will thoroughly hash that out, and I understand the reason; you're saying the President expected 0-3-3, and even with sequestering he continues in his position as Commander in Chief to expect it, so you call it current services.

Dr. MILLER. That's right.

Chairman DOMENICI. But I wonder if it bothers you at all to use current services in the sequestering on domestic accounts from the standpoint that the levels are very arbitrary. Some clearly are not current services, as you and I would have defined them in past years, because they're not the result of any deliberate conduct on anyone's part.

It would seem to me that there must be some items in there that are not right. You and I are delighted tosee $25 billion in budget authority reduction from 11.7 in sequestration. We have been saying that's the issue. Don't move buget authority around. Get an outlay number, and force the BA to fit it, which is what happened under this.

Could you maybe supply us with your best judgment as a policy adviser to the President as to which sequestered accounts are probably too low in 1986 from the standpoint of reasonable service for the people under the function that's attributed to it—if there are any. And that's not asking you to submit a supplemental for each one. But IRS is too low, isn't it? I mean we all think that. Are there some others? Surely it's arbitrary to cut them all that way. You would cut some more and some less, wouldn't you?

Dr. MILLER. Sure.

Chairman DOMENICI. Just give us a list so we get a feel as we look at this how high current services should have been moved up before we start acting off of it.

That would be helpful, I believe.

Dr. MILLER. Certainly.

[The following was subsequently supplied for the record by OMB:]

NO SUPPLEMENTALS REQUESTED

At this time, we would not designate particular current services as being too low to carry out their functions. We believe we can perform our duties within the appropriated funding levels as adjusted by the 1986 sequestration. No supplementals are requested for the purpose of offsetting sequestration.

Chairman DOMENICI. Now, I want to make an observation about this "broke" budget process just in my closing remarks. It is a tough process. But I would hope that every opportunity you have you would help the President understand the process. Let me give you an example.

There is no State as big as New York is or as big as California is that has a budget like the U.S. Government, and that's not the process, that's the budget. Because if you're off 1 percent in your economic assumptions, you have a whopping difference in your budget, right? And that has nothing to do with waste. It has nothing to do with redwood forests that aren't needed or other things. It's just that we have a budget that responds dramatically to those kinds of changes.

So the process is, indeed, onerous. But it would help if we received some understanding from the White House that, indeed, it is a very different budget. Now, I'm not apologizing for a complicated process, but I am from time to time very concerned that some don't seem to understand that a budget like ours with entitlements, and forward funding, and student loans where the interest is predicated on market interest and is sensitive to very big fluctuations that are unrelated to anything we do other than what happens out there in the market.

I think that's a fair statement of at least 50 percent of the problems from all the years that we've been conducting this process.

Now, I'll close by saying thanks to you, and we'll be working with you in the coming weeks. Obviously we need to do some negotiating, but as long as you are willing, we are willing.

We don't know where that will end up, but we'll keep trying.

Unless there's anything further, we stand in recess.

[Whereupon, at 5:15 p.m. the committee was adjourned.]

WRITTEN COMMITTEE QUESTIONS TO WITNESSES AND THE RESPONSES

QUESTIONS OF OMB DIRECTOR FROM MR. GRASSLEY

FEBRUARY 5, 1986

Question 1. First, I would like to remind you that during the hearing on Gramm-Rudman, you promised me that you would get back to me with regard to my question about collaboration between OMB and USDA. You need not answer now, but I would like an answer after today's hearing.

Answer: Gramm-Rudman requires the Commodity Credit Corporation to treat all participants in a given crop year equally. Given the clear statement within the Conference report that commodity programs receive the same treatment as other government agencies, compliance was scheduled to begin with the 1986 crop.

The timing of program announcements is a separate matter. Both OMB and USDA have attempted to expedite these decisions as much as possible to give farmers more information upon which to base crop decisions. The 1985 Farm Bill is a complex piece of legislation which did not take final form until late last year. Ensuring the most efficient, cost-effective program possible has taken much time and effort. However, I can assure you that we have and will continue to make announcements as soon as possible.

Question 2: For instance, Wharton Econometrics has found that unless farm income remains stable, plus a significant investment toward farm debt restructuring, tens of billions of dollars and thousands of jobs will be lost to our economy. Unfortunately, USDA's Economic Research Service performed a real hatchet job on this economic analysis. Further analysis by ERS has found they were wrong.

I would like you to review the second analysis and report to the Budget Committee your findings and whether or not you believe the country can afford your proposed budget cuts to agriculture programs. I want this report before the Senate Budget Committee proceeds with the budget mark-up which is scheduled to begin in March.

Answer. OMB representatives have consulted with the USDA Economic Research Service on the results of their second assessment of the macroeconomic study conducted by Wharton Econometrics. On the basis of our understanding of the latest ERS assessment, the following points are clear:

- As a result of further discussion between ERS and members of the Iowa Center for Agricultural and Rural Development, ERS has not significantly changed its estimates of the macroeconomic impacts of alternative commodity price support program scenarios. ERS continues to believe that the Wharton estimates of farm sector stress on the general economy are overstated by roughly a factor of two. ERS currently estimates these impacts to be in the range of $5.0 to $10.7 billion as compared with the Iowa Center/Wharton estimates of $10 to $20 billion. (The original ERS estimate range was from $4.3 to $9.4 billion.)

- ERS and Wharton disagree principally on the assumptions about the impact of the farm sector loan losses on interest rates outside the farm sector. ERS' point was that the interest rate effects were an assumption driving the Wharton analysis, and not a result of the Wharton model. This point does not seem to be at issue. What is at issue is the most reasonable set of assumptions to use. In the absence of a formal mechanism for deriving estimates, these assumption will rest on the judgements of the respective analysts. For the reasons set forth in the original review, ERS analysts believe that "there is a substantial probability that the risk premium impacts from an agricultural debt default will be much smaller than those assumed by Wharton. Thus, overall macroeconomic impacts in the Wharton analysis are likely overstated as well."

- My staff have reviewed these estimates and believe that the ERS estimates and conclusions are valid.

The Administration believes that prospects for the agricultural finance sector should improve given the legislatively-mandated restructuring of the Farm Credit System which was supported by this Administration. Furthermore, the Deficit Reduction Act should also produce results which are conducive to improvement in this sector. Finally, I would like to point out that the 1985 Farm Bill signed by the President provides at least $55 billion over the FY 86-88 period for price support and related programs for this Nation's farmers. I believe that this needs to be kept in mind when agriculture program budget cuts are being considered.

Question 3. Midwest farmers are concerned about the implementation of Gramm-Rudman cuts for FY 1986 and 87. Soon they will be asked to make good business decisions as to whether or not to sign up for the 1986 farm programs, yet no one has told them how these cuts will be applied. I would therefore like you to report to the Budget Committee before mark-up begins how these cuts will be applied. I also would like a report explaining any differences between USDA's proposals and that which is ultimately announced.

Answer: On February 12th, the Secretary of Agriculture issued an announcement summarizing the application of Gramm-Rudman-Hollings to crop programs. Basically it provides for a cut of 4.3 percent in all cash payments by CCC as required under section 356(j) of the Act. Both USDA and OMB agreed on how these reductions apply to deficiency payments and loan rates.

Question 4. For instance, during the debate of the 1985 Farm Bill, the Administration was supporting a proposal to reduce target prices 5 percent each year. We were told this would save about $1.4 billion over three years in the corn program compared to my preference for a freeze in target prices. My office was also told by USDA's budget office that $80 million is saved for every one cent reduction in deficiency payments to a farmer. If this is true, then $80 million divided into $1.4 billion equals about 18 cents per farmer over three years, or 6 cents per bushel per year.

Yet by reducing target prices 5 percent each year, the farmer really loses 95 cents over three years, or nearly 32 cents per bushel per year.

My point is that if USDA's estimates are correct, for an investment of 6 cents, the government increases farm income by 32 cents.....it has a multiplier effect. I would like your people to report to me with an explanation of this before mark-up begins.

Answer: Your estimate of $1.4 billion in savings over 3 years as a result of reducing corn target prices 5 percent annually from the 1985 level of $3.03 per bushel is essentially correct. It reflects reductions in government payments from two sources: a lower deficiency payment per bushel as the target price declines; and a steadily declining participation rate by corn farmers in the program since fewer farmers are expected to participate as the target price delcines. In order to calculate the total savings from a 5 percent reduction in target prices one would have to measure the effect of such a change on participation, production, and other key variables. Consequently, while a one cent reduction in target price in the first year would result in savings of about $58 million (instead of $80 million), the savings amount declines for each additional one cent reduction due to the foregoing factors.

A 5 percent reduction in target prices annually over the 1986-88 period would have resulted in the following target prices as compared with the 1985 crop level of $3.03 per bushel: 1986 - $2.88; 1987 - $2.73; 1988 - $2.59. Cumulatively, over the 3-year period, corn farmers would lose 89 cents per bushel; 15 cents in the first year; 30 cents in the second year; and 44 cents in the third year.

Since deficiency payments are made directly to farmers, farm income increases on a dollar for dollar basis for the amount of deficiency payments made. Consequently there is no multiplier effect on farm income resulting from these payments.

Question 5. I have also been informed, although I can't find the reference to it in your budget materials, that you are calling for a user fee once again for the Farm Credit System. If that is correct, I would simply remind you that the Administration has supported legislation aimed at putting the Farm Credit System back on its feet, possibly with the help of government funds. It seems quite contrary to that objective to ask for user fees.

Answer 5. The Administration is of the firm view that the Farm Credit Bill of 1985 provides a tangible mechanism that will allow the Farm Credit System to solve its current financial difficulties by utilizing its considerable capital resources. In addition, the restructuring of the Farm Credit Administration will permit the necessary supervisory and regulatory oversight to steer the system away from repeating the mistakes made in the past.

It must be understood that the proposed user fee on new debt issues does not single out the Farm Credit System, but rather it represents a cross-cutting initiative affecting all government sponsored enterprises designed to reimburse the Federal government for the borrowing advantages that these enterprises realize in the Nation's capital markets.

Investors appear to concur with our optimism on the recovery of the Farm Credit System as evidenced by the spread between Treasury issues and comparable Farm Credit System debt issues. Specifically, during the height of the hysteria, September 1985, spreads were above 100 basis points. Currently, the spread has fallen to approximately 25 basis points. No commercial lender could hope to realize such discounts on their cost of funds.

Given the relatively modest scope of the proposed user fees, we believe that neither the system's imminent recovery nor its current competitive advantage in the Nation's bond markets will in any way be compromised.

QUESTIONS FOR JIM MILLER

FROM SENATOR LAUTENBERG

FEBRUARY 5, 1986

ON FINES, PENALTIES AND FEES.

Question 1. I am interested in federal receipts from various fees for permits and regulatory and judicial services, and from various fines, penalties and forfeitures. The value of receipts is reduced in real terms, to the extent fees, fines and penalties are set at fixed dollar amounts in the law and are not regularly updated.

Could you provide the Committee with a detailed listing of each provision of law providing for a fee, fine, and penalty; the receipts in FY 85 and projected receipts in FY 86, FY 87, FY 88 and FY 89 associated with each provision of law; and date of enactment of the last revision of the level of the fee, fine, or penalty. Please estimate the increase in receipts that would result in FY 87, FY 88 and FY 89 if the level of the fee, fine, or penalty were increased to account for inflation for each year since the level was last set or revised. If information pertaining to each provision of law is not available, and please estimate to the extent possible the revenue impact of "inflation-adjusting" fees, fines, and penalties on an annual basis.

Answer: The information you requested is not, to our knowledge, available on a comprehensive government-wide basis. Individual agencies, however, collect some of the data you requested about prior year receipts levels.

ON OIL IMPORT FEES

Question 1. I understand that the Council of Economic Advisers has compiled an analysis of the economic impact of an oil import fee. Please provide the Committee with a copy of that analysis.

Answer: The material you have requested contains confidential, pre-decisional information prepared for discussion among senior White House officials. We do not possess a copy of the analysis.

TARGETTING FEDERAL SUBSIDIZED CREDIT

Most of the information requested by these questions is not available, although individual agencies may collect some such information for programs within their individual areas of responsibility. I am, however, able to provide specific information in response to two of the questions in this category.

Question 5. The Administration's proposal for restructuring the Direct Student Loan Program calls for borrowers to repay their loans on a progressive schedule related to the loan debt and borrower income. However, the proposal for Guaranteed Student Loans calls for borrowers to begin paying an additional 3 percent above the interest rate three years after they enter repayment status, regardless of the amount of loan debt or borrower income. What is the rationale for setting repayment in the one program on an income-related schedule, but not the other?

Answer: The Government provides most (9/10) of the new loan capital to schools for the national direct student loan (NDSL) program. For this reason, there is no reason to suspect that an increase in costs of program administration at the school level would measurably affect the amount of loan capital available to students. This is not the case in the guaranteed student loan (GSL) program, however, where loan capital is provided by private lenders and profitability is a prerequisite for continued lender participation. Since administrative costs would clearly increase, perhaps substantially, under an income-contingent repayment approach, the Administration did not believe that this approach could be used successfully in the GSL program without charging borrowers (and paying lenders) an interest rate well in excess of the 91-day Treasury bill (T-bill) plus three percent proposed for the direct income-contingent loan program.

If the Congress were to develop evidence that the GSL program could be operated on these proposed income-contingent loan terms, the Administration would be willing to explore this option.

Question 6. Has the Administration done an analysis of the effect of increasing the expected self-help contribution to $800? What are the characteristics -- family income, race, type of institution attended, age, etc. -- of students who could and could not afford this contribution? How many students would have to drop out of school because they could not provide the increased contribution?

Answer: All students would be able to afford the $800 self-help contribution. The contribution is not a cash requirement; rather it is an expectation similar to the expected parental contributon. A student could meet the self-help expectation by reducing his living costs, through outside earnings form a summer or other job, or with college work study earnings or loan under any student loan program.

HOUSING AND URBAN DEVELOPMENT QUESTIONS

Question. What was the budget request of the Department of

Housing and Urban Development for the Urban Development Action Grant program? What was the basis for the decision to terminate this program? Why has the Administration submitted both a rescission and deferral request for this program?

Answer: The Department of Housing and Urban Development requested $352 million in budget authority for the Urban Development Action Grant program for FY 1987.

The basis for the decision to terminate this program and rescind 1986 funds was the determination that the UDAG program has an insufficient priority to warrant continued support in the current environment of intense fiscal restraint. The Administration proposes to terminate the UDAG program as part of a Government-wide effort to reduce local economic development subsidy programs that distort economic investment choices and impose Federal priorities on State and local governments.

National economic trends are more important to our cities' economicies than individual Government programs. Since the budget deficit poses the most obvious threat to our Nation's economy, we must reduce Federal expenditures. Congress affirmed this policy direction when it passed the Balanced Budget and Emergency Deficit Control Act of 1985. In light of the urgent need to reduce expenditures, the Administration is proposing to rescind $220 million in 1986 UDAG funds. This action allows Congress to reconsider its prior appropriations action. Because the UDAG program, like many other construction support programs, expends funds slowly over several years, failure to rescind 1986 funds would delay the deficit savings essential to meet deficit reduction targets specified by the Congress.

On December 24, funds were deferred to preserve the opportunity for the Administration and Congress to consider taking action that would affect 1986 funds. These funds were then withheld pending rescission on January 27 to reflect the President's 1987 Budget proposal to rescind $220 million UDAG resources. On February 5, the Administration submitted deferral and rescission reports explaining both of these actions in order to comply fully with reporting requirements pursuant to the Congressional Budget and Impoundment Control Act of 1974.

Question. On what basis was the decision made to seek a deferral of $500 million in Community Development Block Grant funding? Did the Department of Housing and Urban Development request this reduction in the program?

Answer. The Administration decided to seek a deferral of $500 million in Community Development Block Grant (CDBG) to achieve deficit reduction in accordance with the Balanced Budget and Emergency Deficit Control Act of 1985. The 1987 Budget reflects the final decision of the Administration pertaining to the Commity Development Block Grant program. Executive Branch communications leading up to this position are part of the

Presidential decision-making process and are not appropriate for public disclosure.

To achieve significant outlay savings, many programs must be eliminated or reduced. Many of HUD's Community Planning and Development categorical programs are proposed for termination. In addition, the Administration believes that the need to reduce the deficit is sufficiently urgent to require reducing the CDBG program level by $500 million. The President's 1987 Budget proposes to begin this program level reduction in 1986, which further contributes toward meeting the Gramm-Rudman-Hollings deficit reduction targets. This is particularly important because the CDBG program expends funds slowly, as do many other construction support programs.

The Federal Government cannot afford to provide current levels of support for State and local community development expenditures when the 1985 Federal deficit was $212 billion while State and local surpluses have grown to $15.9 billion in 1984. However, to minimize the adverse effects of program reduction on the most distressed communities, the Administration proposes to target the CDBG assistance more toward communities with the greatest need.

AMTRAK QUESTIONS

Question 1. The Administration again requests the termination of Amtrak. Is it the Administration's opinion that the discontinuation of federal assistance will lead to the end of Amtrak service as Graham Claytor, Amtrak President, has stated? Should Amtrak cease operations, triggering substantial labor protection payments, how will these payments be met if Amtrak does not have the ability to meet them? What is your estimate of the amount that would have to be paid and from what source will these funds come.

Answer: Amtrak has cost the taxpayers approximately $12 billion (including the Northeast Corridor Improvement Program) since its inception and could cost another $6-8 billion over the next 10 years. Taxpayers subsidize all of Amtrak's capital needs and about half of its operating costs. No other mode of intercity transportation receives a subsidy this extensive. Eliminating Federal subsidies to Amtrak will not in-and-of-itself lead to the end of Amtrak service. Federal subsidy elimination does not preclude local, state, regional, or private groups from taking over Amtrak service.

Labor protection is the responsibility of Amtrak, not the Federal Government. In the event of an Amtrak bankruptcy, labor protection costs would be a claim against the corporation. The book value of Amtrak's assets totaled over $3 billion at the end of calendar year 1985. If the entire Amtrak system were shut down and none of its employees were rehired in other jobs with comparable pay, labor protection payments would costs $2.1

billion (this is an Amtrak estimate and covers the six year length of the labor protection payments).

Question 4. In relation to Amtrak in the New York to Washington market, what is the Administration's estimate of the impact on alternative modes of transportation should Amtrak cease running? How many more flights per day would this mean between New York and Washington? Would additional investment in airport development, air traffic control, etc. be necessary to meet additional demand?

Answer: On the whole Northeast Corridor, Amtrak passengers totaled 17,500 a day in 1984. On the Boston-New York-Washington corridor during this same period, there were at least 21,000 airline seats daily that went unfilled. Although some like to paint a picture of 17,500 passengers a day flooding National and La Guardia airports if Amtrak service were terminated, this is simply not the case. In fact, direct travel between New York and Washington accounted for only about 12% of NE Corridor passengers in 1984 (2,020 passengers). Shorter routes, such as Philadelphia-New York, accounted for a much higher percentage of passengers, and it is on these routes that passengers would turn to buses, auto, and commuter trains, rather than airplanes.

Bus load factors average 55% in the Northeast. From 1971 to 1984, intercity bus service between Washington, D.C. and New York City (measured in roundtrips per day) decreased from 79 to 41, or by 48 percent. Bus service is expected to increase if Amtrak service terminated.

While it is reasonable to assume that a majority of the unfilled airline capacity is during off-peak hours, it is also likely that a combination of increased bus service, changes in passenger behavior (i.e., willingness to fly during off-peak hours), and increased use of the highway would produce in the aggregate little disruption to the transportation system and require no transportation investment other than that which is planned.

Question 5. What was the Department of Transportation's budget request for Amtrak?

Answer: DOT's request to OMB involved a three year phaseout of Federal funding for Amtrak. 1987 was to be the first year of the three year phaseout, with $400M in a Federal subsidy (new budget authority) requested by the DOT.

MASS TRANSIT QUESTIONS

Question What was the Department of Transportation's budget request for the Urban Mass Transportation Administration?

Answer: The Department request, for general and trust funds combined, was $1,968 million in 1987 budget authority, limited to $1,540 million by obligation limitations on the formula block grants. The components of the BA request include:

Administrative Expenses:	$26.8M
Washington metro:	$212.5M
Formula Block Grants:	$1,573.2M
Operating Assistance:	$155.9M

The FY 1987 request would continue to provide capital for replacement and rehabilitation projects, support existing transit capital improvement projects, promote private sector transit alternatives, and fund operating assistance at a reduced level when compared to FY 1985 and FY 1986.

CONSTRUCTION GRANTS QUESTIONS

Question 1. In making your recommendation on funding construction grants, did the Administration calculate to what degree state and local taxes will have to be increased to make up for this loss of Federal funds? (If not, please provide that information to the Committee.)

Answer: There is no presumption that State and local government must raise taxes to offset the lower Federal subsidy. While some may choose to initiate tax increases, many states can increase appropriations to this effort out of existing revenue bases. Also, several alternative funding sources are available that can substitute for, or be combined with higher tax rates.

Alternatives to Federal financing have always been available. Municipalities can still finance waste treatment plants in the traditional way -- by issuing long term bonds. Moreover, the charging of local water and sewer fees that fully cover O&M and replacement costs will help achieve compliance goals without Federal assistance and will prevent premature plant deterioration. EPA has indicated that over half of all communities do not charge sufficient water and sewer fees to cover operating expenses. This means that proper and necessary O&M and replacement expenditures are not being made.

In addition, innovative state programs are expanding. Revolving funds are now operational in 12 states and under study in 21 states. Eleven states have their own infrastructure banks that operate loan or bond programs. For new project starts, rapidly growing interests by the private sector to build and/or operate municipal waste treatment plants is providing an additional alternative to Federal funding.

Because each state's current revenue base is different and the method of taxation may vary, it is not possible to calculate the tax increase necessary even if it is assumed that the entire Federal subsidy is replaced by an increase in tax.

Question 2. Did the Administration calculate the impact of slowered economic growth that would result from an increase in construction bans because municipalities cannot meet the 1988 secondary treatment requirement for sewage treatment facilities?

Answer: No. There is no Federal authority to impose a construction ban on municipalities that fail to comply with the 1988 deadline, and such a ban is not contemplated as part of the EPA National Municipal Policy. Certain states such as New Jersey, however, can impose construction bans, but these are based solely in state authority.

For non-delegated states, EPA intends to address major permittees that fail to comply with established schedules through the normal process authorized by the Clean Water Act -- administrative orders and referrals to the Department of Justice.

It should be noted that compliance with the 1988 deadline is not relevant to the President's Budget level for the construction grants program or to the phaseout program that has been proposed. Only about one percent of new budget authority is outlayed during the year is appropriated. Fiscal 1987 funds, therefore, will have a de minimus effect on construction needed to comply with the 1988 deadline. In fact, only about ten percent of FY 86 funding would be outlayed by July 1988.

Question 3. Does the Administration recommend that we weaken federal water quality standards as a response to its budget deficit?

Answer: No. The legislation submitted by the Administration on February 4, 1985 proposed no changes to secondary treatment requirements or to ambient water quality standards for stream segments. The obligation to meet effluent and ambient standards is the same for municipalities as it is for any other private sector dischargers and is not dependent on the availability of a Federal subsidy.

EPA OPERATING BUDGET

Question 1. In FY 81, the EPA operating budget (everything except for Superfund and Construction Grants) was approximately $1.35 billion. The Administration's FY 87 proposed operating budget is $1,377 billion. How big a cut does this represent -- in real terms -- from 1981 level? Please provide the same information for FY 82-FY 86 budgets?

Answer: In 1987 dollars the 1981-1986 budgets would be $1.65B, $1.29B, $1.73B, $1.27B, 1.38B and $1.47B respectively.

It is obvious that a comparison over time is only relevant if the mix of activities remains the same throughout the period. In a regulatory/enforcement agency, such as EPA, the mix changes dramatically from year to year. Some programs complete their regulatory mission and are phased out or delegated to the states, and other new programs begin their regulatory mission.

For example from 1976-1983, EPA conducted a major water pollution discharge regulatory effort, and the annual budget rose from $5M to $29M during the period. Now that the regulations are issued it would be inappropriate to continue funding the program at prior year levels. On the other hand, new RCRA regulatory requirements had just been enacted. In 1987 major increases over prior year levels are needed to accommodate that mission.

Clearly, the only way to budget an agency like EPA is to do an annual assessment of appropriate funding levels for each program, to set priorities among the programs and to budget for those activities so they are completed in a cost-effective manner. The relationship of one year's totals to any other year's totals is not relevant.

Question 2. Since 1981, EPA has received additional responsibilities, like those under the 1984 Amendments to RCRA. How can EPA do a credible job, with less resources, and more responsibilities?

Answer: First, there have been no new legislative requirements imposed on EPA since 1981, except for the 1984 Amendments to RCRA. Budgetary resources for that program have increased steadily since 1984 -- and will dramatically increase again in FY 1987.

Second, when viewed by appropriation account EPA resources are increasing. The research and development, and regulatory/compliance accounts have both increased from 1984-1986. The salaries and expenses account increased steadily from FY 1983 except for 1986 which is slightly reduced due to Gramm-Rudman-Hollings reductions, but will again increase $33M in FY 1987. These increases in the current and prior years -- as well as the FY 1987 President's Budget -- have enabled the Agency to address significant, emerging environmental issues on both a media-specific and cross-cutting basis.

Third, and most importantly, the agency is always able to shift resources from lower priority programs (or programs completing their mission) to meet higher priority (or newly emerging) progarm needs. A few examples:

- o Within the air program, increased emphasis is placed on addressing hazardous air plutants as part of the Air Toxics Strategy.
- o Within the water program there has been a shift from program development to program implementation. There has also been a reduction in the water program due to completion of court-ordered effluent regulations and

phaseout of the construction grants program. However, there have been increases in enforcement to implement the National Municipal Policy.

- The RCRA program has increased dramatically since 1984 and the passage of the 1984 Amendments. As one of the Agency's highest priorities since 1984, BA has increased by 100% and staff resources have expanded by almost 50%.

As these few examples demonstrate, as long as EPA is viewed as a dynamic set of activities it is quite reasonable to expect that meeting new obligations can be accomplished without large annual increases in budgetary resources.

Question 3. What request did you receive from EPA to fund its operating programs?

Answer: EPA requested $1,606,469,000 to fund its operating programs.

Question 4. What specific programs did EPA request in the following areas: (include funding and program description)

Answer: a. Air Toxics. EPA requested a total of $36M and 348 FTE. The increase was to implement the Agency's Air Toxics Strategy to control continuous and sudden releases of toxic air pollutants.

b. Radon. EPA requested 22 FTE and $2M for this new initiative, in which the agency proposed to initiate a national sampling survey to locate and characterize radon concentrations, and provide measurement and remediation assistance to states and locals.

c. Asbestos. EPA requested $4.5M and 12 FTE to provide technical assistance to building owners and managers, and to fund contractor certification and regional information programs.

d. Groundwater. There are two separate groundwater protection activity levels.

Within the Office of Drinking Water a separate Groundwater Office has been established to highlight and coordinate EPA's actions under current authorities to protect the Nation's groundwater. The FY 87 budget request was $2.3M and 28 FTE.

In addition, since EPA's legislation often focuses on the protection of groundwater, an overall groundwater protection investment program has emerged. During FY 865 over $180M and 1,000 FTE and in FY 87 over $100M and 1,400 FTE are devoted to the protection of groundwater. These activities are found in both the regulatory and research programs and across all of EPA's media programs.

e. Nonpoint Source Pollution. EPA requested 30 FTE and $2M in the nonpoint source (NPS) area. These resources were requested to oversee regional and state programs, target other federal programs, and provide technical support for NPS implementation.

Question 5. For EPA's operating budget, which requests do you reject and what was the basis for these rejections?

Answer: a. Salaries and Expenses. Major increases for personnel compensation and benefits and to restore government-wide reductions, such as the 10% administrative cost reductions, were not provided. EPA's request was counter to Administration policy for all government agencies to seek grade reductions and productivity increases and not to fund or encourage grade creep. A small increase in expenses per FTE was included to reflect inflation.

b. Nonpoint Sources. No resources were provided for EPA to force or leverage state or local nonpoint source programs since it has been repeatedly shown that the choice of appropriate techniques entails highly sensitive local land use decisions, which must remain outside of any Federal control. Instead, EPA's focus will be on encouraging other Federal agencies to adopt appropriate management practices on Federal lands.

c. New Facilities. No funds were provide for new facilities because of the overwhelming need for budget restraint and the availability of adequate alternative space.

SUPERFUND QUESTIONS

Question 1. The Budget Appendix states that, (quote) "A revised request will be developed and submitted to Congress once the program is reauthorized." (unquote)

Please describe what this statement means. Does the Administration stand ready to work with Congress in support of a level higher than the $5.3 billion original recommendation?

Is the President ready to accept, support, and seek a request for the level Congress agrees on?

Answer: The President's FY 1987 Budget request for Superfund of $1,050 million reflects the budget planning level consistent with the President's $5.3 billion legislative proposal for reauthorizing the program. Many activities and several agencies would normally be allocated funds within that total to carry out Superfund activities. The decision was made, however, not to develop a 1987 budget proposal in any detail due to the Congressional delay in reauthorizing the program and uncertainty as to the specific requirements the revised legislation would impose. At the time our budget process began, neither the House nor Senate had passed a bill, and only one of five House

Committees with jurisdiction had even reported a bill. Consequently, the Administration decided that development of a detailed 1987 budget for Superfund should wait until after new legislation is enacted.

The Administration still strongly opposes enactment of a program that exceeds $5.3 billion over 5 years, since this is the maximum level that EPA can manage effectively. However, once the program is reauthorized, the Administration will revise the 1987 Superfund budget level, if necessary, to implement those requirements of the new legislation which have 1987 budget implications.

Question 2. Please provide a comparison between the program functions planned under the President's request and the program functions that are embodied in the House and Senate Superfund reauthorization bills.

Please provide an estimate of the additional funding that may be necessary to fund the reauthorized Superfund.

Answer: The most important program functions for Superfund are similar under the House, Senate, and Administration bills. All three bills give primary emphasis to emergency response, remedial action, and enforcement. The House and Senate bills differ from the Administration bill in authorizing several additional programs to be financed out of Superfund. The major new authorizations are:

	House	Senate
Innovative and Alternative Technology Grants	$100M	$125M
Health Research and Training	$98M	$110M
Worker Safety Training	$50M	$50M
University Research Centers	$25M	--
State Matching Grants	--	$250M
Total	$273M	$535M

If funded at their fully authorized levels, these major new programs would increase the five year program cost by $273 million in the House and $535 million in the Senate.

Additional funding would also be needed to implement existing functions more rapidly or under different requirements than proposed by the Administration. For instance, the failure of the House and Senate to increase to 20 percent the state matching share for remedial actions will increase program costs by almost $300 million.

Many of the other new requirements cannot be priced out at this time but will clearly increase program costs unnecessarily. As an example, the House cleanup standards are likely to increase site cleanup costs significantly despite providing little or no additional environmental protection. However, at this time, it is impossible to quantify how much this provision will cost.

Question 3. In the OMB passback to EPA on the Superfund program, $48 million was deleted from EPA's request.

Please justify that deletion. Please describe the impact that the deletion will have on the program in regard to the EPA justifications for the original, higher request.

Answer: The reduction in EPA's request reflects the decision to request a total funding level consistent with the Administration's proposed legislation, but not to develop a detailed 1987 budget for Superfund until after reauthorization. The reductions were not made for programmatic reasons. Once legislation is enacted to reauthorize the program, a 1987 budget will be developed to fully meet the 1987 program.

Question 4. The Superfund Trust Fund should be entirely self-financed in the reauthorized legislation. Use of the funds is restricted to the Superfund program, including interest paid on the fund. If Congress approves a 33% to 50% larger fund than supported by the Administration, how will the Administration justify not adjusting the President's request if the alternative is to have the funds build up, unspent, while sites remain in urgent need of cleanup monies?

Answer: The Administration strongly opposes enactment of a program larger than $5.3 billion over five years. However, if a larger program is enacted, the Administration will develop its future budget requests to meet the requirements of the new statute in each year.

Several factors might affect the Administration's yearly budget requests for the program. These include EPA's ability to effectively manage the program from year to year, the length of the Congressional delay in reauthorizing the program, and the appropriate mix of activities required of EPA and other participating agencies.

These are the same factors that Congress will have to face in the appropriations process. In the past, Congress has not always appropriated all money that was available for appropriation due to fiscal constraints and the inability of the program to obligate money as fast as it was collected. In fact, Congress appropriated less than requested by the Administration in two of the first five years of the program.

OBLIGATED AND UNOBLIGATED BALANCES
IN
THE DEPARTMENT OF DEFENSE

A Review
Prepared by the Staff of the
Committee on the Budget
United States Senate

April 10, 1986

OBLIGATED AND UNOBLIGATED BALANCES IN THE DEPARTMENT OF DEFENSE

OVERVIEW

The Chairman of the Senate Budget Committee, on February 6, directed the joint staffs of the Committee to prepare a paper reviewing unexpended balances in the Department of Defense. The purpose of the paper is to: (1) define unexpended and unobligated balances; (2) review historical patterns of growth in unexpended balances; and (3) review reasons for their occurrence.

DEFINITIONS

The three categories of balances which are discussed in this paper are defined as follows:

Unobligated Balances: The sum of funds that remain available for obligation, i.e., for which no obligation or commitment has been made.

Obligated Balances: The sum of all funds that have been obligated for a specific use or purpose but have not been disbursed from the Treasury.

Unexpended Balances: The sum of all funds, obligated and unobligated that have not been disbursed. They are simply the sum of unobligated and obligated balances.

HOW DO THESE BALANCES COME ABOUT?

Full Funding Accounting Procedures. The Congress has a number of ways to make spending authority available to a department or agency. Virtually all of the spending authority in the Department of Defense is the result of a direct appropriation of federal funds. These appropriations fund all of the programs of the Department of Defense such as the pay of people, the operations of the forces, and the capital programs necessary to replace equipment and facilities as they wear out.

The Congress insists on the concept of full funding for the investment programs of the Department of Defense, which means that if the Congress intends to approve a program or project, then it will provide the full funding for that program or project. For example, if Congress approves the construction of a building, the full cost of that building is appropriated even though the construction may require several years.

There are several distinct advantages to the full funding method of budgeting. One is that it insures that future Congresses will not be forced to provide funds to complete partially funded programs. Another reason is that it accurately reflects the cost impact of a decision made by the Congress. Since many of the defense programs are by nature capital investments, such as construction of ships, aircraft, and other weapons; and take years to complete, the Congress funds these programs with appropriations that have a multiple year life. This means that these appropriations are available to be obligated, i.e., legally committed for a period longer than one year. If they are not obligated within the specified period, the funds lapse and are returned to the Treasury. As a general rule, the appropriations to the various Department of Defense accounts are for the following periods:

Account	Term
Military Personnel	1 year
Operation and Maintenance	1 year
Procurement	
(except Ship Construction)	3 years
Ship Construction	5 years
Research, Development, Test and Evaluation	2 years
Military Construction	5 years

The term of each appropriation is usually specified in the legislation and can be varied.

After the Congress has passed an appropriation bill and the President has signed it, the department begins to execute its approved programs. As contracts are signed or other commitments are made, obligations are recorded against the available funds. These obligations represent the legally binding commitments made by the government. The process of registering an obligation against a fund balance is very important since it measures the value of the outstanding commitments made by the government and identifies funds that are still available for use. Once the contract is signed and the obligation is recorded, the contractor begins work and may bill the government for work-in-process. When DoD issues a check in payment for the work, an expense in the amount of the check is registered against the account, and the funds are referred to as expended. At the end of the life of each appropriation, the amount of funds that are unobligated lapse and are returned to the Treasury. Those funds that are obligated, however, remain on the books until all bills for the goods and services for which they were obligated have been paid. If any funds still remain, they are deobligated.

Accounts Generating Balances. Normally the process of budget execution is measured at year-end. Therefore, accounts that have only a one-year life do not contribute to unobligated balances since all funds not obligated at year-end lapse. Only accounts with a multiple year life can generate unobligated balances that carry over into the next fiscal year.

TABLE 1. Composition of Unobligated Balances in DoD by Account ($ in billions)

	84	85	86	87 est.
Procurement	39.9	46.1	45.7	46.9
Research, Development, Test, and Evaluation	2.7	3.3	3.9	4.9
Military Construction	3.9	3.8	3.2	3.7
Family Housing	0.3	0.4	0.4	0.5
Revolving and Management Funds	4.8	7.9	6.7	4.3
Total	51.6	61.5	59.9	60.3

Obligated balances exist in all accounts since there is always a lag between the time a commitment is made and a check is issued. The distribution of these balances by account is given below:

TABLE 2. Composition of Obligated Balances in DOD by Account ($ in billions)

	84	85	86	87 est.
Military Personnel	1.3	1.3	2.0	2.6
Operation and Maintenance	19.9	25.0	28.2	33.1
Procurement	101.6	120.2	130.7	148.6
Research, Development, Test, and Evaluation	13.7	17.3	21.2	30.5
Military Construction	4.4	5.7	6.9	8.5
Family Housing	1.6	1.7	2.1	2.9
Revolving and Management Funds	10.7	11.2	11.1	12.8
Other	0.3	0.5	0.2	0.3
Total	153.5	182.9	202.4	239.3

Revolving Funds. There are 29 funds in the deparment that are defined as revolving and management funds. The largest of these, by far, are the stock funds and industrial funds. Each service has one of each, plus one defense-wide fund, so that there are a total of five of each. The stock funds buy most of the spare parts and lower cost items for DoD in order to have those items on the shelf and ready to go when they are needed. The industrial funds are similar except that they offer industrial repair or other services instead of spare parts. Both funds make purchases (or repairs) in advance of an appropriation and "sell" to the operating forces upon demand. The "sale" is actually a transfer of budget authority from the operating unit to the fund and serves to replenish the obligation authority of the fund. Once a fund has been established, it does not require any additional budget authority from the Congress to operate unless the Congress wishes to expand its size. These funds receive relatively little budget authority, yet they have sizable unobligated balances since they make substantial purchases every year. Because of the unique nature of these funds, and the numerous and varied technical issues that affect them, they are best analyzed separately. Table 3 provides a summary of the transactions of these funds for the last three years.

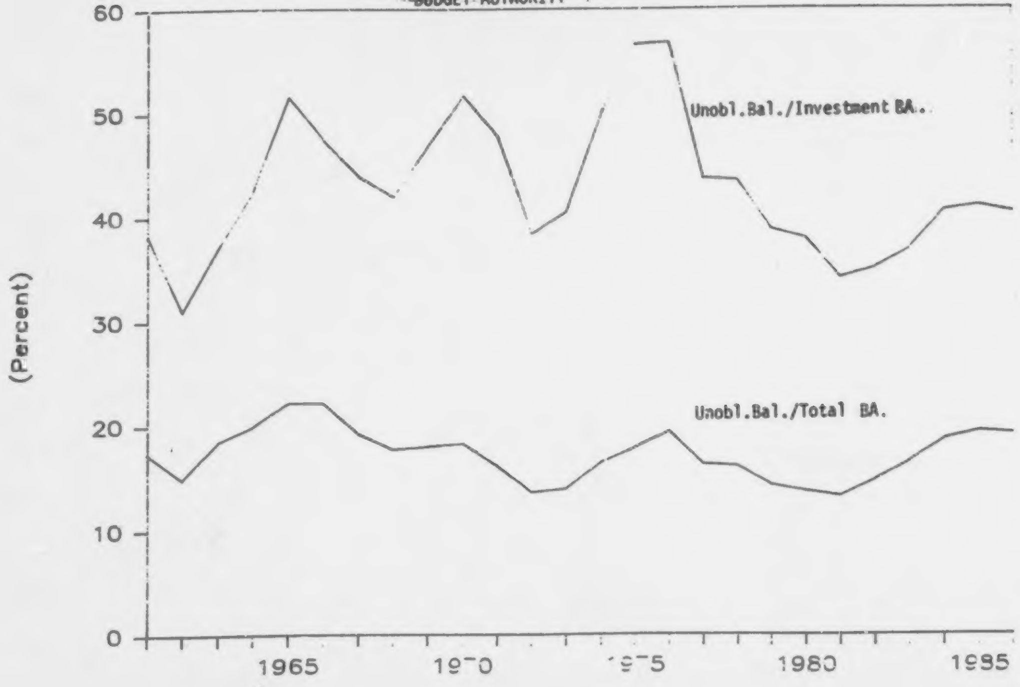
TABLE 3. Balances in the Revolving and Management Funds
($ in billions)

	FY 1985	FY 1986	FY 1987 est.
Unobligated Balance Brought Forward	3.7	6.5	6.6
New Budget Authority	5.8	2.2	1.2
Receivables	71.5	73.1	70.2
Total Available for Obligation	80.4	81.8	78.0
Obligations	73.5	75.2	73.7
Year-end Unobligated Balance	6.5	6.6	4.2
Percent of Total Available for Obligation	8.1%	8.1%	5.4%
Year-end Obligated Balance	11.1	11.1	12.8
Percent of Total Available for Obligation	13.8%	13.6%	16.4%

NOTE: Totals may not add due to rounding or other technical corrections.

CHART 1

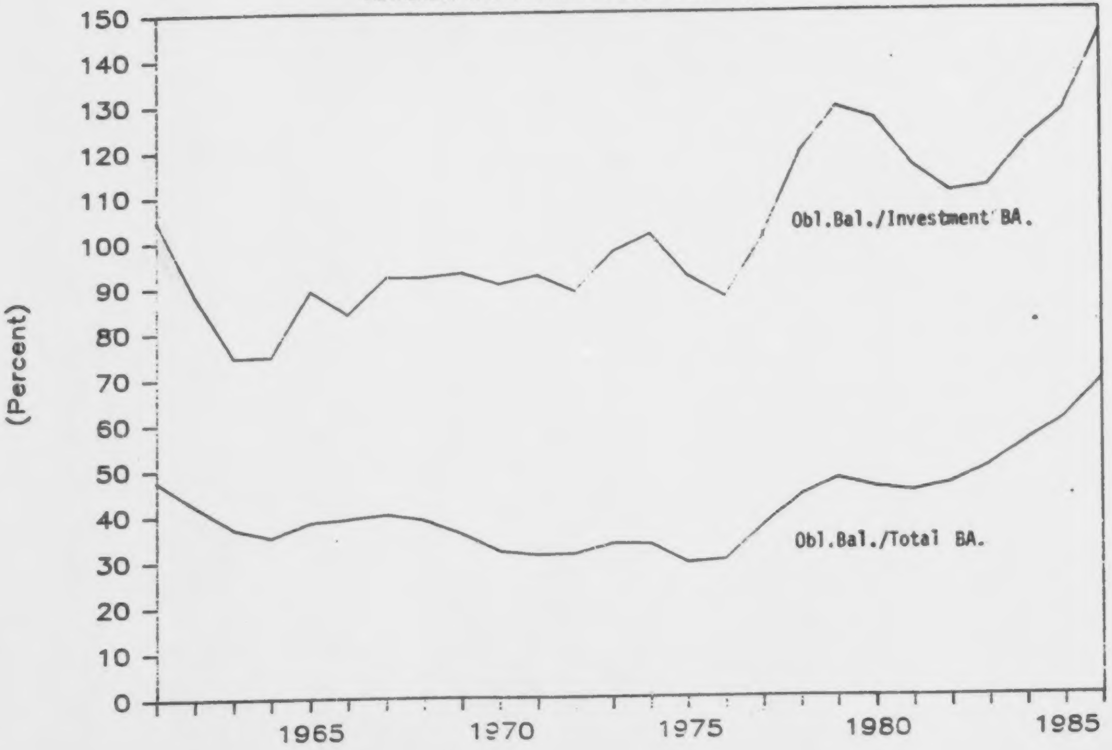
UNOBLIGATED BALANCES AS A PERCENTAGE OF TOTAL BUDGET AUTHORITY & INVESTMENT BUDGET AUTHORITY



Investment Budget Authority+Procurement + RDT&E + Military Construction

CHART 2

OBLIGATED BALANCES AS A PERCENTAGE OF TOTAL BUDGET AUTHORITY & INVESTMENT BUDGET AUTHORITY



Investment Budget Authority+Procurement + RDT&E + Military Construction

It is important to note that excess funds can and do build up in the revolving funds. This has happened recently with the rapid decline in fuel prices. Excess funds can be removed from these revolving funds in several ways. One way is to lower "prices" to the users. Another method, which was used in recent appropriation bills, is simply to establish a credit in each Operation and Maintenance account for a stock fund rebate or price reestimate. Finally, a revolving fund cash balance can simply be removed or transferred by law.

Trends in Balances. Table 4 provides a history of obligated and unobligated balances since FY 1961. Since these balances are generated by the budget authority made available to the department, the history of total budget authority is also provided. Table 4 also shows these figures adjusted for inflation.

The data shown in Table 4 demonstrates that both obligated and unobligated balances have risen dramatically in recent years. The balances however, are not independent variables, but are influenced by many factors, the most important of which is the level of budget authority provided by the Congress. For example, Table 1 shows that at least 75 percent of the unobligated balances for each year are in the Procurement account and over 90 percent are in the three investment accounts--Procurement, Research and Development Test and Evaluation, and Military Construction. Therefore, it is obvious that as budget authority increases in these accounts, unobligated balances will also rise. The same point applies to obligated balances. Therefore, to facilitate a quick review the best way to portray the historical data on obligated and unobligated balances is relative to the amount of budget authority that is enacted.

A second problem that makes it difficult to evaluate the levels of these balances is the presence of large unobligated balances in the revolving and management funds. The funds have obligational authority to purchase parts and services in advance of an appropriation so that the parts and services will be available when needed. The obligational authority of the fund is replenished when the parts are "sold" to the operating units. The characteristics of these funds are that they have large unobligated balances but require little or no new budget authority. Since the purpose of the paper is to shed light on the budget execution process, it is necessary to separate the revolving funds from the other accounts to get a clear picture of how well DOD is executing its program.

Charts 1 and 2 provide a history of obligated and unobligated balances (with the revolving and management funds removed). These balances are expressed as a percentage of total and investment budget authority (Procurement, RDT&E, and Military

Table 4

History of Unobligated and Unobligated Balances in DoD
($ in billions)

	Current Dollars			Constant Dollars		
Fiscal Year	Unobl. Balance	Oblig. Balance	Total BA 1/	Unobl. Balance	Oblig. Balance	Total BA 1/
1986 est.	59.9	202.4	278.4	62.0	209.4	288.0
1985	61.5	182.9	286.8	65.6	195.1	306.0
1984	51.6	153.5	258.2	57.0	169.6	285.3
1983	43.4	128.7	238.7	49.3	146.3	271.3
1982	34.6	107.6	211.6	40.8	126.8	249.3
1981	26.5	86.3	176.0	33.5	108.9	222.2
1980	24.2	67.9	140.7	34.6	97.0	200.9
1979	23.0	60.9	123.7	36.7	97.1	197.2
1978	21.3	52.4	114.6	36.9	90.7	198.4
1977	20.0	42.7	108.1	37.4	79.8	202.1
1976	21.0	30.3	95.7	42.2	61.0	192.5
1975	16.7	27.1	85.7	35.9	58.2	184.0
1974	15.1	28.6	81.0	35.3	66.9	189.5
1973	12.7	26.9	77.6	32.0	67.7	195.4
1972	11.9	24.0	75.0	32.4	65.4	204.4
1971	13.0	23.0	71.2	38.4	67.9	210.3
1970	14.8	25.5	74.1	46.6	80.3	233.4
1969	14.9	29.5	76.9	50.2	99.3	258.9
1968	14.8	30.9	76.3	52.4	109.4	270.2
1967	15.1	32.1	72.2	55.9	118.8	267.3
1966	15.8	26.9	63.6	61.0	103.8	245.4
1965	13.6	19.5	49.1	56.4	80.9	203.6
1964	12.7	17.5	49.6	54.4	75.0	212.5
1963	11.7	18.7	49.6	52.2	83.5	221.4
1962	9.9	22.1	48.0	45.0	100.4	218.0
1961	9.9	20.6	49.4	45.5	94.8	227.2

1/Subfunction 051, Department of Defense.

Sources: Budget of the United States Government, FY 1963-FY 1987.
Historical Tables, Budget of the United States Government, FY 1987.

Construction). For example, the first data point on Chart 1 is 17.4, which is the ratio of the FY 1961 year-end unobligated balance of $7.2 billion to the FY 1961 budget authority figure of $41.3 billion for the investment accounts.

Chart 1 shows that the unobligated balances, although they have been rising recently, are well within historical experience. For example, in FY 1986 unobligated balances are 40.4 percent of investment budget authority. This compares to an average of 42.3 percent for the decade of the 1960s, 46.8 percent for the 1970s, and 37.6 percent for the first half of the 1980s. That is not to say that they could not be lower (or higher) but only that the data is inconclusive and more detailed analysis would be necessary before drawing a conclusion. By contrast, the ratios of obligated balances to both total budget authority and investment budget authority shown in Chart 2 have been steadily rising and are at all-time highs. This suggests that the buildup in defense has created a rising backlog of work to be performed, but it is not evidence that excess funds exist.

WHAT ARE THE CAUSES OF THESE RISING BALANCES?

Budget analysts have identified specific factors that affect the level of obligated and unobligated balances. The are: (1) increases in budget authority; (2) program mix; (3) decreased inflation; (4) management; (5) complexity of weapons; and (6) other reasons.

Increases in Budget Authority. Obviously the most direct cause of rising obligated and unobligated funds is the level of authority enacted by the Congress. As budget authority rises, it is only logical that both obligated and unobligated balances will rise as well. For example, over the last decade (FY77-FY86) unobligated balances have nearly tripled (from $21 billion to $60 billion), but the size of the procurement account has grown by an even larger percentage (from $21 billion to $93 billion). By relating these balances to the relevant levels of budget authority (as is done in Charts 1 and 2) it is easier to analyze their size.

Program Mix. A second factor that affects the level of these balances is the program mix. In FY 1976 the Procurement account comprised 22 percent of the enacted budget authority of the Department of Defense. In FY 1986 it comprises over 33 percent. By shifting to a mix of programs that contains more slow-spending accounts, one would expect the rate of obligation and expenditure to slow down and the levels of these balances to go up. Table 5 contains a summary of details on program mix over the last 10 years.

Table 5
Defense Program Mix
Percent of Total Defense Budget Authority

	Fiscal Year									
	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Military Personnel	31	30	30	29	27	26	25	24	23	24
Operation and Maintenance	29	30	30	32	31	29	27	27	26	26
Procurement	25	25	25	25	27	30	33	32	33	32
Research and Development	9	10	10	9	9	9	9	10	11	12
Military Construction/ Family Housing	3	3	3	3	3	3	3	3	3	3
Atomic Energy Defense	2	2	2	2	2	2	2	2	2	3
Other	1	-	-	-	1	1	1	2	2	-

Decreased Inflation. A third reason is the significant decrease in inflation. When inflation drops rapidly, as it has recently, many of the goods and services end up costing much less than was budgeted. These excess funds simply build up in the accounts. These excess funds will remain as unobligated balances until they lapse or are transferred or reprogrammed.

Management. Management has a big impact on these funds as well. Over the last few years, good management, economic production rates, increased competition and other management techniques have produced savings. Many of these funds have already been reclaimed by Congress within the appropriation process, but excess funds may continue to result from improved management. Funds also accumulate in these accounts because of bad management, technical problems, and political problems. Any program that is delayed because of technical, management, or political problems generally falls far behind its schedule and accumulates large unobligated and/or obligated balances. For example, when the DIVAD was cancelled, approximately $0.5 billion was made available for other uses.

Complexity of DoD Weapons. The weapons and equipment purchased by the DoD have become increasingly complex. With complexity have come longer lead times to build and buy these weapons and equipment. As the lead times have gotten longer, so have the time periods between enactment, obligation, and disbursement of funds. This would have a small effect on unobligated balances, but a very large effect on obligated balances. For example, if every item funded by the procurement account took one month longer to deliver, the level of obligated balances would rise by about $10 billion.

Other Reasons. There are other factors that affect the rate of obligations and expenditure of the various accounts. Recent initiatives requiring separate procurement procedures for spare parts, increased audit activity, warranties, and increased competition have generally slowed the procurement process. These initiatives are all directed toward saving money, and if one accepts the premise that they are working, then the savings are likely to increase the level of unobligated balances. Some analysts have indicated that the rapid increase in the size of the DOD investment accounts has strained the capacity of DOD and industry to perform on these programs, and thus slowed the rate of execution.

Undoubtedly, all of these factors have contributed to the rise of unobligated and obligated balances. It is difficult, if not impossible, to isolate the impact of each particular factor. Perhaps the comparison that is most troubling to many analysts is the one shown in Table 6 which traces the estimates of unobligated balances and the associated budget authority

Table 6
Chronological Estimates of Unobligated Balances

	FY 1984			FY 1985			FY 1986		
	Unobl. Balance	Total 051 BA	Invest.* BA	Unobl. Balance	Total 051 BA	Invest.* BA	Unobl. Balance	Total 051 BA	Invest.* BA
FY 1984 Budget Request	45.5	273.4	129.5						
FY 1985 Budget Request	43.0	258.1	117.4	50.5	305.0	148.7			
FY 1986 Budget Request	51.6	258.2	117.5	51.5	284.7	133.8	55.7	313.7	153.2
FY 1987 Budget Request	51.6	258.2	117.6	61.5	286.8	133.7	59.9	278.4	131.6

*Investment= Procurement + RDT&E + Military Construction through three budget years. Using FY 1985 as an example, the table shows that DoD was predicting unobligated balances of $50.5 billion resulting from a total budget authority of $305 billion for the department (subfunction 051). Now that FY 1985 is complete, unobligated balances at the end of FY 1985 total $61.5 billion, $11 billion higher than originally estimated, while total budget authority is $18.2 billion lower than was requested. The figures show that the same process is occurring in FY 1986.

The FY 1985 variance is largely the result of the $6.3 billion of unobligated funds that were identified and redirected in the FY 1986 Continuing Resolution, PL 99-190; a technical change in the law governing obligations for navy ship leases; and program variances caused by Congressional restrictions, audit requirements, delays in negotiating warranty provisions, and other program and administrative delays. Despite these reasons, the fact remains that DoD is not executing its program as quickly as was forecast. This inability to execute the defense program as rapidly as planned has resulted in elevated levels of obligated and unobligated balances, but has no direct inference regarding the availability of those balances for other purposes.

The General Accounting Office, in a recent report 1/, estimated that as much as $7.5 billion of defense appropriations for FY 1986 could be excess funds. The estimate made by GAO is an adequate estimate of the potential for excess funds in the President's request, but it does not attempt to estimate the excess funds that actually exist. The difference lies in the fact that GAO did not attempt to analyze the impact on excess funds of the defense authorization and appropriation acts, nor of the Gramm-Rudman-Hollings FY 1986 sequester.

The FY 1986 appropriation bills reduced the President's requested budget authority by $25 billion dollars. It is unclear precisely how much of this reduction was excess funds, but the defense appropriation bill made a specific reduction of $1.7 billion in FY 1986 inflation funds and many of the other reductions appear to be pricing adjustments, i.e., reductions in the amount of dollars provided but no quantity reduction or other programmatic change. Furthermore, the GAO made no effort to incorporate the Gramm-Rudman-Hollings reductions in their analysis. A total of $13.3 billion of budget authority of the Department of Defense was cancelled as a result of the FY 1986 sequester. Should one assume that the $25 billion reduction in defense funding made by the authorization and appropriation

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1/Budget Issues--Potential for Excess Funds in DoD--March 1986 Update, GAO/NSIA-86-76, March 1986.

legislation did not remove the $7.5 billion of estimated excess funds, it is inconceivable that the $13.3 billion sequester missed them as well.

CONCLUSION

The analysis of the data for obligated and unobligated balances of the Department of Defense indicates that DoD has not met the rates of obligation and expenditure that were planned, and that levels of obligated balances are at historically high levels. Unobligated balances have risen also, but that rise is largely explained by the rise in enacted budget authority. It is inevitable that some additional savings may occur, especially in the slow-spending accounts and it is possible that jurisdictional disputes may render some FY 1986 defense funds unusable, but the conclusion of this analysis is that the FY 1986 appropriation bills plus the Gramm-Rudman-Hollings sequester have removed the vast majority of these excess funds.

BACK UP DATA
FOR CHARTS 1 AND 2

	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974
Unob. Balance	7.2	7.1	9.2	10.0	11.0	13.9	13.7	13.5	13.7	13.6	11.5	10.2	10.9	13.4
Oblig. Balance	19.7	20.2	18.5	17.6	19.0	24.6	28.8	29.7	27.3	23.8	22.3	23.6	26.2	27.2
Total (Unexp)	26.9	27.3	27.7	27.6	30.0	38.5	42.5	43.2	41.0	37.4	33.8	33.8	37.1	40.6
Enacted Net Total BA	41.3	47.8	49.8	49.9	49.4	62.5	71.4	76.1	76.1	74.3	71.4	75.2	77.7	81.2
Procurement	11.7	15.7	16.6	15.6	13.8	20.0	22.9	23.4	20.5	17.9	15.7	17.8	17.5	17.0
R&D	6.0	6.4	7.0	7.0	6.5	6.7	7.2	7.3	7.6	7.4	7.1	7.5	8.0	8.2
Mil. Constr.	1.1	0.8	1.2	0.9	1.0	2.6	1.1	1.5	1.2	1.0	1.3	1.3	1.4	1.6
Total	18.8	22.9	24.8	23.5	21.3	29.3	31.2	32.2	29.3	26.3	24.1	26.6	26.9	26.8
Unoblig. as a % of:														
Net Total BA	17.4	14.9	18.5	20.0	22.2	22.2	19.2	17.7	18.0	18.3	16.1	13.6	14.0	16.5
Investment BA	38.3	31.0	37.1	42.6	51.6	47.4	43.9	41.9	46.8	51.7	47.7	38.3	40.5	50.0
Oblig. as a % of:														
Net Total BA	47.7	42.3	37.1	35.2	38.5	39.3	40.3	39.0	35.9	32.0	31.2	31.4	33.7	33.5
Investment BA	104.8	88.2	74.6	74.9	89.2	84.0	92.3	92.2	93.2	90.5	92.5	88.7	97.4	101.5

BACK UP DATA
FOR CHARTS 1 AND 2

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Unob. Balance	15.4	18.7	17.7	18.5	17.9	19.4	23.2	31.4	39.7	47.8	54.9	53.2
Oblig. Balance	25.1	28.0	40.7	50.6	59.5	64.7	78.9	98.5	120.1	142.6	171.3	191.1
Total (Unexp)	40.5	47.5	58.6	69.1	77.4	84.1	102.1	129.9	159.8	190.4	226.2	244.3
Enacted Net Total BA	85.8	95.7	108.4	115.0	124.8	142.0	176.4	212.0	238.8	256.0	282.2	277.0
Procurement	16.7	21.0	27.9	29.5	31.4	35.3	48.0	64.5	80.4	86.2	96.8	92.6
R&D	8.6	9.5	10.4	11.4	12.4	13.6	16.6	20.1	22.8	26.9	31.3	33.7
Mil. Constr.	1.9	2.4	2.2	1.6	2.3	2.3	3.4	4.9	4.5	4.5	5.5	5.3
Total	27.2	32.9	40.5	42.5	46.1	51.2	68.0	89.5	107.7	117.6	133.6	131.6
Unoblig. as a % of:												
Net Total BA	17.9	19.5	16.3	16.1	14.3	13.7	13.2	14.8	16.6	18.7	19.5	19.2
Investment BA	56.6	56.8	43.7	43.5	38.8	37.9	34.1	35.1	36.9	40.6	41.1	40.4
Oblig. as a % of:												
Net Total BA	29.3	30.1	37.5	44.0	47.7	45.6	44.7	46.5	50.3	55.7	60.7	69.0
Investment BA	92.2	87.5	100.5	119.1	129.1	126.4	116.0	110.1	111.5	121.3	128.2	145.2

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1987

THURSDAY, FEBRUARY 6, 1986

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 1:45 p.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kassebaum, Andrews, Symms, Grassley, Kasten, Quayle, Gorton, Chiles, Hollings, Johnston, Sasser, Hart, Metzenbaum, Exon, and Lautenberg.

Staff present: Stephen Bell, staff director; Charles Flickner, senior analyst for international security; and Paul Heilig, analyst for national defense.

For the minority: Richard N. Brandon, staff director; Douglas Olin, senior analyst for national security affairs and technology; and Doug Cook, senior analyst for defense.

Chairman DOMENICI. The committee will come to order.

We are going to get started. I apologize for a brief delay. Yesterday, I shocked everyone and started promptly. I could not do that today, but in the future we will try to start committee meetings as close to the announced time as possible.

Yesterday, I departed from our normal process of having opening remarks made only by the chairman and ranking member and let others make opening remarks. I regret that. I'm only kidding, but I did learn a lesson—good faith goes only so far and then it takes up a lot of time.

So, we will revert back to the previous procedures that we have had for a number of years, and try to hold everybody to their time as we move through so that everyone can have adequate time to make an inquiry.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. So, let me open by saying, good afternoon, Mr. Secretary. I am glad to welcome you once again to testify before our committee. Admiral Crowe, this is the first time before the Senate Budget Committee for you and we welcome you. We also would like you to know that tomorrow the Congress goes out and that means that after tomorrow evening, you can go to work for a week. I understand you are testifying twice a day for the next 2 or 3 weeks, except for the President's recess. We are glad to have you and I congratulate you on your selection as Chairman of the Joint Chiefs and give you my best wishes for your tenure. That statement is on behalf of this entire committee.

Admiral CROWE. Thank you, Senator.

DEFENSE HAS DECADE OF REAL GROWTH

Chairman DOMENICI. I would like to mention just a brief bit of history. Mr. Secretary, and Admiral Crowe with the committee's indulgence, let me talk for just a moment about the past. About 10 years ago, some of us on this committee, including Senator Hollings and Senator Chiles, joined together to insist that the budget resolution for the upcoming fiscal year reflect real growth in defense spending. Our efforts forced a change in policy and the then-President began a real growth path in defense for the rest of his administration.

Then, when President Reagan was elected, defense growth accelerated. As a result, defense has had real growth for a decade. I believe that we achieved growth just at the right time, perhaps even in the nick of time. I believe our actions were warranted by the national security threats and by neglect of defense spending for a decade, perhaps, across the board, but for certain in some very specific areas. As the result of the President's leadership and your tenacity and the work of Congress, defense spending has increased substantially since 1980, it has almost doubled. The morale of the troops continues to soar as you have told us and as we have found out for ourselves. Our readiness seems to be, at least to this Senator, to have improved; and the Nation, once again, does not hesitate to honor those who serve us. It is more than just money that has caused this turn around, but money has helped in many critical ways.

DEFENSE MUST CONTINUE TO INCREASE

Speaking for myself, I am not ready to allow a wholesale reversal of that policy. I believe that defense must continue to increase. I think that it would be a national and international disaster to suffer the second sequestration in October of this coming year.

I know that some analysts say that all of our spending has bought us less in new weaponry and brought us less advances than some think we should have, but that kind of analysis often ignores the qualitative improvements that the new weapons systems have given us. In 1980 we had M-60 tanks, M-113 armored personnel carriers and Cobra helicopter gunships as primary pieces of equipment for all our ground forces. Today, we have the M-1 tank, Bradley fighting vehicle, and the Apache helicopter—these new machines are better in all respects. They cost a lot more and they take a lot more time to be built. Our commanders in Europe are saying that in the last autumn, reforger exercise, the M-1 tank was so good compared to M-60 that it equated to having another entire division of tanks.

Now, this is not a simple payoff and some will continue to say that it is not real. I believe it is. In short, I believe that our commitment is paying dividends, in a more secure country that is better able to defend itself and to have an impact on what happens in this world.

We face a real testing time, as I see it, for the first time since I have been in the Senate, defense budget authority this year, the year of 1986, is actually lower than last year's budget authority. Even for those who might have thought that it was too high to begin with, that certainly is not any way to run the defense of our country. The President has asked for an increase of about $34 billion in budget authority and we have a number of options. I believe that we have at least a few—the Department could live with a smaller increase than that requested, however, as I said, yesterday, I personally would rather see a tax increase coupled with domestic spending cuts so that we can provide our defense with an adequate increase. I do not want to see the clamity of that sequester, as I indicated, and so, clearly, we have to do a lot of compromising. Those who want the President's budget exactly as it is in all respects, must compromise too.

Let me conclude by noting that Admiral Crowe yesterday said in testimony before the Congress that the odds right now, in a specific military conflict between Soviet and American forces in the Pacific is 50/50.

WHAT WILL BE LOST FROM CUTS

If that is a correct quotation and surely, I hope that the admiral will address that at the appropriate time in his remarks, then it gives me some reason to pause. It leads me to end with this question and I know everyone here is interested in it. Congress has cut the President's initial defense requests made back in 1982 by hundreds of billions of dollars. Obviously, some of that is because of better economic times, less inflation and lower costs that are attributable to economic factors.

But I would like to know what those cuts have cost us? What have we been unable to purchase in the way of weapons, equipment, training forces and the like that we would have otherwise gotten?

If we cut even further, and the President's request is much lower for the next 3 years than it was 2 years ago, what will we be losing out on?

I think this is a critical question and even though we do not deal in the details it is a kind of a question that I believe is on many of our minds.

I will yield to the distinguished Senator from Florida for his opening remarks.

OPENING STATEMENT OF SENATOR CHILES

Senator Chiles. Thank you, Mr. Chairman.

Mr. Secretary, this year, if Gramm-Rudman-Hollings works in the way the sponsors of the legislation intended, we may begin to make some tough choices in both our defense and domestic priorities.

The debate is sure to be difficult and complex, but this afternoon I would like to dispel two fallacies that may have grown up in the last 5 years, in our review of the defense budget.

REAL GROWTH BECOMES SOLE FOCUS

The first is the fallacy of real growth or preoccupation with the top line. Using real growth as the primary measure of a commitment to a strong defense was an invention of a previous administration. It has become the sole focus of this administration with little attention given to the net assessment of the threat or strategy for deterrence.

As we discussed last year, defense spending has grown by over 50 percent in real terms since the beginning of your tenure and in fiscal year 1986, the defense budget is $60 billion higher in real terms than the peak year of the Kennedy buildup.

It is essentially equivalent to the peak years of the Vietnam and Korean wars. Unfortunately, the record of the buildup is mixed and the accomplishments are somewhat modest. In a fiscal sense, the indicators are especially critical, according to a CBO study conducted at my request. Unit prices for major weapons systems jumped dramatically during the first 2 years of the buildup. If you will look at the numbers there, the M-1 tank 45 percent; the M-2-3 fighting vehicles 64 percent; all the way down to the F-16 aircraft at 24 percent.

Further, a number of organizations like the Congressional Budget Office, GAO, your own Comptroller and the Military Reform Caucus, have concluded we significantly over-funded inflation in the Department of Defense between fiscal years 1983 and 1985. Those estimates range from $23.3 billion from CBO up to $49 billion with the Military Reform Caucus, but your own estimates are $24.5 billion.

Some of that over-funding is attributable to a steady drop in worldwide oil prices and still more is tied to a 30-percent multiplier of major weapons systems, which came into play during fiscal year 1982. While some of this over-funding has gone to pay higher prices, more has gone into the pipeline of unobligated balances which have more than doubled since fiscal year 1981. Ironically this is the same rate as the investment accounts have grown in procurement, research and development.

If we look at the historical trend which is 16.2, then we see that the unobligated balances have gone all the way from $26.5 billion to 1984, $51.6 and 1985, I think, is in the $60 something billion range.

PROFITABILITY TREND WIDENS IN OUTYEARS

A larger point that has been lost in the spate of procurement scandals is the extent to which defense contractors have benefited from the buildup. A report commissioned by the Secretary of the Navy went into great detail in this matter. The study determined that in 22 corporations it reviewed, the U.S. Government business was nearly 2½ times as profitable as their commercial business performed by the same corporations. Now, even more startling, I think, Mr. Secretary, is to see how that profitability trend gets wider and wider as we go into the outyears, as we go from 1980 into 1984.

The Navy concluded that in order to correct this situation, we have to lower profits by reducing prices and the best way to reduce prices is by increased contractor investment in productivity measures. The issue of profitability does not cover the full extent to which the defense industry has benefited from the buildup. I asked the General Accounting Office to look into the question of deferred taxes through the use of completed contracting method of accounting. Their report indicated that the principal user of this questionable method was the defense industry and the top 20 users of the method with declared pretax income of $43.7 billion between 1981 and 1984, deferred $4.4 billion in taxes during that period of time.

Mr. Secretary, the programmatic record is also quite spotty. In the report I referred to earlier, CBO determined that for four aggregate indicators of defense capability—for stucture, modernization, readiness and sustainability—only modest improvements have been made since 1981. In fact, as a result of higher prices, the report concluded that we actually bought fewer combat aircraft during fiscal year 1982–85 period than we did from 1977 to 1980.

One of the justifications given at the beginning of the buildup for major funding increases, was our desire to establish effective production rates for weapons systems. I asked the General Accounting Office to look into how well we were progressing toward establishing guidelines and procedures to achieve these rates in the production of major weapons systems. Their conclusion, again, is quite troublesome. The GAO determined that your office has not yet established formal written criteria for reviewing and selecting weapons systems on which to collect production rate data. Furthermore, they concluded that the cost for reducing systems below their effective production rate, exceeded by nearly $1 billion the savings achieved by having some of the systems at their effective production rate. Mr. Secretary, the report went further to state, that your office had not followed the recommendations of its own Acquisition Improvement Group which had urged that some tough choices be made between weapons systems in production.

That group has also argued to slow the growth of new starts. It is my understanding that in one study conducted recently by the Department of Defense, it was estimated that in its own internal budget process, the Department of Defense has routinely, since fiscal year 1983, stretched 40 percent of its major programs.

Moreover, the study concluded that this percentage would have been higher if the individual services budget estimates had been accepted. We can only conclude that the result of decentralized management has been to lose the ability to set priorities and to make tough choices.

Despite these sober and critical findings, this year may present us with an opportunity to do something worthwhile.

ENACTING THOUGHTFUL ACQUISITION REFORM

On that note, I wish to dispel a second fallacy, the notion that Congress alone can enact thoughtful acquisition reform. Last year we saw what can happen when good intentions get carried away. This year we have two positive vehicles through which we can address these difficult issues. The first is the Packard Commission which is due to release its report this month. Perhaps more important than its report, is the ongoing work of your own Office of Acquisition and Logistics. In a report dated November 1985, this office detailed the problems and suggested the solutions. It has been disturbing to hear recently that their legitimate criticisms were being muted. Finally, Mr. Secretary, I want to briefly comment on the potential impact of a Gramm-Rudman-Hollings sequester.

I do not believe that that sequester would be a good policy. My staff estimates that such a sequester would result in a reduction of $50 billion from the President's request. That is equivalent to a 10-percent real reduction. Mr. Secretary, reductions of that sort would result in a repeal of 30 percent of the build-up. While I have seriously questioned the rate of the recent defense build-up, I have never questioned its purpose—the need to maintain a strong and reliable deterrent is the primary responsibility of the Federal Government.

However, it is clear that we must find a more reliable way to perform this mission. Mr. Secretary, we are in this together and if you are serious about improving and reforming the acquisition process, we will work with you. I have great respect for the career professionals in the Department of Defense and I am convinced that with their knowledge and guidance we could establish—and can establish—an effective and efficient productive system.

RECENT DEFENSE BUILDUP UNPRECEDENTED

In conclusion, Mr. Secretary, the recent defense buildup has been historically unprecedented—funding increases now we see are showing us only modest improvements. The prime beneficiaries have been defense contractors who have benefited from higher prices as well as overly generous profit and tax policies.

Decentralization has resulted in more systems and productivity than significant increases in production and efficiency. The time is right to correct past deficiencies. Downward pressure on the budget could create the atmosphere needed to make the choices, which were bureaucratically impossible before. I hope you are willing to work with us to achieve this goal of thoughtful acquisition reform.

Chairman **Domenici**. Thank you very much, Senator Chiles.

Mr. Secretary, you may proceed.

STATEMENT OF HON. CASPER W. WEINBERGER, SECRETARY OF DEFENSE

Secretary **Weinberger**. Thank you, Mr. Chairman.

Mr. Chairman, and members of the committee, I am certainly willing to work with you, Senator Chiles. I am not really willing to sit here and listen to a lot of misstatements and erroneous statements that reflect on the men and women of the Armed Forces. And when you say that the principal beneficiaries have been the contractors, you are making, I think, a very grievous and unwarranted assumption with respect to the true beneficiaries of what we have been trying to do.

The true beneficiaries are the American people. Chairman Vessey, after 46 years of service in the United States Army retired last year, and he said that the American military is stronger in every way, that in all of the years of his service, he had never seen them better supported, better led, better equipped, better trained, and with higher morale. They are the beneficiaries of what we have been trying to do. You have made a number of points here for which I am glad because it gives me a chance to refute them so I will set aside the 45-page statement that I had prepared.[1]

I will give a little of it, you are not free of it completely. But I do want to deal with some of the points you have made, because I think you have been the victim of some very wrong information.

OUTPUT SHOULD BE OUR CONCERN

I think first we should deal with the question of real growth and the preoccupation with it and I could not agree with you more. In my first confirmation hearing, 5 years ago, I said that the idea of measuring everything by a percentage of real growth was not the way to deal with the very serious situation, that we faced then and still face to some extent. We have to be concerned with output. What is it that we get for what it is that we put in?

There are all kinds of academic studies as to how much the Soviets spend compared to how much we spend. They try to put it into rubles and what it would cost us to buy the Soviet program, and all of that. The important thing, is what do they get? And they get a great deal more than we do each year.

Probably because they spend more, probably because they have such criminally low wages, probably for a number of reasons. The fact is that they do and that is the important thing and the only relevant thing, from our point of view as to what are they getting and what are we getting. And what we are getting is the best military force in our history. That was testified to yesterday by the present chairman and by General Vessey earlier. These are the things that I am proud of and these are the things that should not be torn down by incorrect figures.

I haven't the faintest idea where the figures on the increases of weapons systems came from. They are nothing that I have ever seen before and they are basically totally at variance with ours.

Our figures are that, indeed, major weapons systems, 84 of them, including all of those that you showed on that chart, experienced cost growth of 1 percent or less for the 2 recent years.

Senator CHILES. My figures came from the Congressional Budget Office. I do not know how biased they are and how incorrect they are. It is just the arm we, in the Congress, try to use to get information.

Secretary WEINBERGER. I understand. I want to put before you the information that we have from the people who buy the weapons and the people who pay for them. Our figures show that there were, indeed major increases in the major weapons systems, up until 1981 and over into fiscal 1982. They used to run from 14 to 17 percent and in 1982, it was 14 percent a year, for 84 major weapons systems.

OVERRUNS ARE FULLY CONTROLLED

Now, for the last 3 years, it has been less than 1 percent and that is a figure that we have had a great deal of difficulty getting anybody to notice. I am always pleased to read about it, but it is always in my own speeches. The fact is that it is true. It is the measure, one of the best measures of the improved management that we have been able to make in the Department. And it is true, that therefore overruns, we think, are fully controlled now.

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[1] See p. 144.

Part of it is due to the fact that we have got an enormously increased volume of competitive contracts. We are up to 72 percent now, of contracts that are competed as opposed to something around 40 percent when we came. We also think that it is due to good management. We follow the programs very carefully with meetings that I have every 2 weeks on major weapons systems, and we ask only two questions, are you on time and are you under budget, and if not, why not?

That is what brought the B-1 program in well under budget, well ahead of time and gives us a plane that we have needed for at least 15 years.

OVERFUNDING WRONG PHRASE TO USE

You mentioned overfunding. Overfunding is a product of the estimates that you and your staff and ours and our staffs at OMB make of inflation. It frequently goes the other way—you are making estimates of what will happen 18 to 22 to 25 months out. And when you make an estimate of inflation that long, and you do not really feel that the policies of the government are going to produce anything more than a continuation of inflation, you put those figures in and that is what OMB did and what was accepted when we first came. It is true, that the President's program has managed to get inflation well below the estimate, but it can go the other way. In the previous administration, you estimated inflation at 7 percent and it came in at 14 percent and then you have got a great big minus sign instead of a plus sign.

Now, what did we do with this? We gave a lot of it back to the Treasury and we asked you to reprogram it and you gave permission and we used it to buy more defense than we had bought before with the same dollars. So, I do not think that overfunding is the way to phrase it. I think that the way to phrase it is that we did get ahold of inflation and we used the funds for purposes of getting defense for a lot less than we otherwise would have had to spend.

UNOBLIGATED BALANCES ARE A FUNCTION OF FULL FUNDING

Unobligated balances—I have heard the problem discussed and described since I used to be Director of OMB, and it does seem to be impossible to get an understanding of it. An unobligated balance is a function of full funding—full funding by every budgetary expert and every budgetary authority who has ever looked at it, is the way to fund your programs. Put in at the beginning, the amount of authority that is needed to pay for the whole aircraft carrier. Do not put in the amount of authority you will spend in 1 year—put in the amount that you will have for the whole cost of that carrier, because that is the only thing that gives the Congress, the people and the economists and others interested in the state of the economy exactly the cost of that ship and what it will do to your other priorities and so on.

So we finally got a full-funding basic principle accepted and, indeed, we do put in full-funding and if we have a carrier that is going to take us 7 years to build, and cost us $1 billion, we ask for authority for $1 billion. We then do not obligate all of that the first year, because, first of all, we do not have any bills in, and second, we do not owe anybody anything. Of course, we do not pay it out, and of course, it is unobligated but it is authorized so that you can finish the carrier and not have to wonder each year if we are going to be able to get a vote that is going to enable us to put a rudder on or something like that.

So, that is what unobligated balances are. They are a function of full-funding and it is a good thing, and if we find out when we finish the carrier, as we will with this one, that we can do it with $850 million instead of a billion. That authority then reverts to the Treasury exactly as it should. But the fact that it is there while you are waiting to pay your bills is not a subject of criticism.

It is a matter of allocating and paying out your bills as they come in, in the most efficient manner. So that is important to note.

PROCUREMENT REFORMS PREFERRED

You mentioned rather casually procurement scandals, as if it is some sort of an accepted fact. What has happened with the procurement problem is the product again, of the fact that we had the highest number of auditors and the largest and most intensive number of contract audits in the history of the Department. We found a great many things wrong and we corrected them. The only problem was that as we found them, each one was attributed to us even though that was not the case and each one was taken as an example of something that was going very wrong and was blowing up and was used by a lot of opportunistic demagogues to try to hurt the defense effort of the country.

What we have to do with that is put it into the proper perspective. First, of course those prices were outrageous, that is why we did not pay them. Of course they were outrageous and that is why, if one or two had slipped through, we got refunds for them That, I think, is a vital thing to bear in mind when you talk about procurement scandals. I prefer to talk about procurement reforms based on problems that we found and corrected.

As far as the profitability trend, yes, the completed contract method of accounting, which enables many manufacturers to defer their tax payments, is wrong and that is why we told the IRS about it and that is why we urged that it be changed. That is why there are provisions for it in the tax reform bill, to change it.

It enables you to defer payment on your tax until you complete the contract, and what we need, is a provision that ends that and allows the Secretary, or anybody you want, to certify that the contract is sufficiently completed so that the profits made thus far should be taxed. We do not have any problem with that at all. We urge that, and have urged it right along.

But that is one of the things that gets into some of the profitability problems here. The other thing that you mentioned, was the——

Senator CHILES. There are two parts to profitability. One was the uncompleted contract and the other one was that there were two and a half times more profit in the defense business than their civilian business.

Secretary **WEINBERGER**. You do have a big profit if you do not have to pay taxes What I am saying, the two are tied together and that they should not be. You should not have your completed contract method of accounting nor should it enable you to defer your tax payments.

Senator **CHILES**. The chart that showed the 2.5 percent does not take into account the tax purposes. That is a separate thing. That is an addition.

Secretary **WEINBERGER**. We think that is one of the major factors as to why there has been that degree of profit in the contracts. We also did have a large number, when we came, of noncompeted contracts, and we are now, as I say, up to 72 percent competed. We are getting a lot better prices and we are doing it because of the improved management and improved audits.

ECONOMIC RATE OF ACQUISITION CRITICIZED

There was another point there that was raised in a highly critical sense. It was how we were no longer getting the best economic rate of acquisition or economic rate of procurement. It is quite true that we did have a number of our budget requests for authority on outlays cut back and in trying to deal with that, and that is what we have had to do this year, particularly, we have indeed had to stretch out and lose the benefits of the most economic rate of production that we had obtained in the beginning. We did that because we felt that the weapons systems involved were necessary and that the Congress had agreed that they would appropriate for them and authorized them and we had them coming in at a rate that would enable us to get much lower unit cost. A lot of that was lost as we have had to cut back year after year from our requests. That certainly happened, and will happen again this year, and certainly will happen in subsequent years. You have to put that money in at the beginning if you want to get the most economic rate of acquisition and we are not able to do it, if we start in with an economic rate and then have to spread it. That indeed, stretches it out and that, indeed, causes problems.

Senator **CHILES**. Mr. Secretary, the 40 percent stretch-out that I am talking about are provisions in your budget now. That is what you are telling us to give you—the 40 percent stretch-out.

Secretary **WEINBERGER**. That is the only way, in view of the past cuts that we can continue to acquire the weapons systems that we need with the funds available.

Senator **CHILES**. It is the only way if you will not agree to ever cancel a weapons systems.

Please tell us what would be your priorities for weapons systems so that we can make those cuts? You have refused steadfastly to ever give us any kind of a list of priorities. We do not know how do that, so, of course, we do put some money in hoping that you will make some choices. But you never make a choice. You have never cut a weapons system out.

Secretary **WEINBERGER**. That is not correct. That is totally incorrect.

The thing that is in the budget represents our list of priorities after cuts have been made and I am perfectly willing to cancel weapons systems when it becomes clear that they will not work and will cost more to finish than is required. I canceled the DIVAD. The first one that we canceled was the original MX basing plan because it was extraordinarily expensive and was not effective. So you have a lot of programs that have been canceled.

The criticisms that come on this stretching out business and that we should cancel are from people who do not like particular weapons systems. They are the people who urged us to cancel B-1, and they are the people who urged us to cancel D-5. They are the same people who urged us to not go ahead with an advanced technology bomber and so on.

They want programs canceled. Stretching out is the product of having your original requests cut.

BALANCE OF MILITARY POWER REESTABLISHED

Those are the points that you made and I did want to answer them at the beginning so I appreciate the opportunity now. I would say with respect to our own presentation, this is the sixth time I have appeared before Congress to present our requests and to ensure that our security interests are protected. During the previous 5 years, the Congress and the administration have shared the common goal and the Congress has been very generous about funding it and it has helped reestablish the balance of military power that we have to have if we want secure deterrence in the years ahead.

The product of that commitment has been enormously impressive and that was the other point you made, Senator, and I did want to bring this out in my own presentation.

Because, together the Congress and the President have restored national pride and they have restored international respect for the United States. The quality of the men and women in uniform has never been higher. They have never been better trained or better supplied or better led, with better morale and better support. We are getting very large quantities of necessary weapons deployed to our forces. Admiral Crowe will take this up in greater detail.

But to say that there have only been marginal acquisition, will be, I think, pretty well dispelled by the charts that I hope to show you in a moment or two.

The other product of that has been the fact that we now have a Soviet Union back at the negotiating table after they swore up and down they would never come back. We have their leader talking with the President of the United States in negotiations which we very much hope can lead to major reductions in weapons systems. We have the fact that the Soviets have not conducted any more of the aggressive actions which they had beginning in the mid-1970's with Angola and ending in 1979 with Afghanistan. They have not gotten out but they have not done any more. We believe the reasons that they are back at the table, talking with the President, and have changed their very aggressive probings which led to invasions, is because they recognize correctly that the United States has gained very great strength. If there are some in various offices here who do not believe we have this great strength that the Soviets clearly believe that we have, and our military clearly believes that we have, those, I think, are extremely important opinions to put into this equation.

FEW DISPUTE RISKS WE FACE

Few dispute the risks that we face today. You said you did not, Senator Chiles, and the chairman said that he did not and we did not encounter anyone in the committees, yesterday, who felt that there were no risks or no threats.

It really is a question of what form of insurance policy we want to take out. Soviet military capability continues to grow unabated and it moves to confront the United States throughout the world and risks to regional stability abound, even here, in our own hemisphere, difficult as it seems to be to persuade people that we need to resist those too.

While the strategic and conventional challenge to our security continues, we also have terrorism and low-intensity conflict as additional risks and yet, in the face of this situation, there seem to be some who feel that our defense efforts must now be relaxed, not because the risk is diminishing, not because the threat is going down as the deficit goes up, but because a modern and responsive military capability they say, cannot be afforded by the United States.

Well, I have never accepted that assertion and I do not now. I think that we have to ask ourselves three major questions. Are we, for any reason, prepared to cut American strength in ways that increase the risks of war? Those who judge that to reduce the deficit would require us to underfund the programs previously agreed to, by the President and the Congress, should stand up and say so and not simply say that they are for a strong defense, but they are unwilling to do anything about it when it comes to voting a budget.

The other question that we have to ask is, with arms reductions negotiations going on and the second summit near, is this really the time to tie the President's arms behind his back rather than strengthening his hand?

I do not think that we should make any mistake at all that influencing the Soviet Union's willingness to negotiate is their judgment of what we will do if they do not. What possible incentive is there for them to make reductions if we are going to do it voluntarily and unilaterally?

Then I think that we should ask if America is not a lot safer than we were 5 years ago? Would anyone really want to go back to the United States-Soviet relationship of the seventies or to the strength of the military, that you, on this committee and others recognized, and started to do something about in 1979 and 1980?

REDUCTIONS MADE BY DEFENSE DEPARTMENT

We are certainly preoccupied with deficits and we have to be. We have had a great deal of talk about how much the Defense Department has contributed to the deficits. I think it is important to point out that deficit estimates are a product of estimates of outlays based on Presidential budget submissions and what happens to them. In 1984, we made reductions in our estimates of outlays and then in our actual outlays in 1984 to the point where we reduced $10 billion, but the Federal deficit went up $11.6 billion. In 1985, we reduced our outlays by $19 billion and the Federal deficit went up by $31.9 billion. We reduced outlays in 1986, after all the Gramm-Rudman-Hollings and other reductions, $43.4 billion and the Federal deficit, the overall Government deficit went up $25.7 billion.

If we had not made those reductions, you can just add the amount that we reduced our estimates and our outlay actuals and add that to the deficit and that would be the deficit that we would be facing now.

In fact, these figures have always led me to conclude that it is not only dangerous to reduce defense spending because of what it does to security, but it is dangerous because it seems to lead automatically to an increase in Federal deficit.

Everytime we do down, all of that is added back in and used to increase other spending. So we have made major contributions, we have had good management practices, and the President has been enormously successful in controlling inflation, and that has enabled us to get a lot more for less and a lot more than we had predicted we could get.

The balance has been returned to the Treasury or used for other purposes.

The Defense budget has become, as I have said, the target of a lot of opportunistic demagoguery, and our own security has suffered.

Even before the Gramm-Rudman-Hollings cuts in 1986, we had a $24 billion reduction from the President's request. You can see that in 1986. [See chart 1, p. 168.] It started out back in March 1981. We made reductions successively through 1985, in the amount of $42 billion in that 1986 budget. In 1985, when it was submitted to the Congress, we came down another $11 billion ourselves, and then we took $24 billion out of it, or it was taken out during the year. Gramm-Rudman-Hollings took $11 billion more so that we were down $88 billion from the original March 1981 estimate.

The current top line, at that point, is $278 billion. Outlay adjustments have come down the same way.

GAIN MOMENTUM

The authority and outlays for 1985, 1986, and 1987, are shown on this chart to give you the usual 3-year picture. [See chart 3, p. 170.] As you will see, in budget authority for 1986, as the chairman said, we are down below the amount for 1985 for the first time in 15 years. The 1987 figure represents an attempt to get well, to gain the momentum and to do it in keeping with the resolution that the Congress adopted last August.

The resolution that the Congress adopted last August said that defense for 1987 should be $314 billion, with outlays of $278 billion, and that is in the budget resolution and it is the tasking that we were given by the Congress. It was the result of an agreement with the President that we would have zero this year and for next year, we would have 3 percent and 3 percent on top of that.

Because we realized minus 6.3 percent growth this year, not zero, and we more than followed the congressional direction of last August to come in at $314 billion, by requesting $311 billion, we have, I think, in every way complied with that agreement and with what Congress told us to do as recently as August.

I think we ought to ask ourselves, what has happened since August that has reduced the risk? What has happened that makes it perfectly possible to make another deep reduction after the amount that we were told last August was required after an agreement between the Congress and the President that resulted in the passage of that resolution?

If anybody believes that that risk has been reduced, or that the need for America to stay strong has, in any way been weakened, they certainly are not people that we are talking to, and we have not found anyone in either House who has said that.

So, we have to worry very much when we have a situation in which, no matter what figure we might come in with, we are told that we always will need less.

RISKS NOT REDUCED

The next chart shows some of the reasons why we do not feel that this risk has, in any way, been reduced and it shows the output over the years 1975 to 1987 of the Soviet Union and the Warsaw Pact countries and ourselves and NATO countries. You can see, in every major weapons systems except surface warships, we have been heavily out-produced by the Soviet Union. [See chart 6, p. 173.]

This is what I had in mind when I said that the only relevant thing is what do you get? Not whether it is a 3-percent, or a 2-percent, or a 5-percent real growth or what the topline is or what the bottom line is; it is what do you get for it?

This is what the Soviets get for it.

It is a very worrisome situation. The next chart shows what will happen with this year's budget of ours, if it is fully funded. [See chart 7, p. 174.] You will see there what the Soviets produce, on the average, every year, 1981 to 1985, and you will see how very large those amounts are, over what we are asking.

You will see from the last bar, what this year's budget would produce for us and, in each, it is well under the large totals that the Soviets produce, year after year, on the average, over a very long period of time.

So you can see, I believe from this, that what we are seeking now is not only not excessive, but as some critics said yesterday, it is not even going to close the gap. You are not going to come up even. Well, of course we are not.

For one thing, we are not trying to get one more tank than they are, but we are trying to regain military strength which can give us the deterrence we need, when we need it. That is what is so vital, and that is what we have begun to do.

That is why we have a much better hope of getting the kinds of real reductions that we feel are absolutely necessary, which we know we cannot get if the Soviets have no incentive whatever, as they sit there and watch us cut our budget down to the point where we suffer very major damage. The next chart shows the force structure that we need and some of the problems we will have with that. [See chart 12, p. 179.]

NEW PEOPLE NEEDED

As we authorize, and appropriate for, and acquire new ships, we obviously need new people to operate them, so we have asked for a force increase of 12,000 in the Navy and very much smaller increases in the Marines and the Air Force, leaving the Army level; a total of 14,000.

Selected reserves have gone up substantially. They are now over 1 million, higher than at any point in our peacetime history, and we think that this is an essential part of it.

Civilian manpower goes up a bit in the department because we have very intensive audits, and because, for one thing, we have been told that we need to file with the Congress 676 new reports this year alone, and this is not the report. This is a single page listing of all of the reports that are required this year, and that is going to take some manpower, and I hope you will excuse us if we are a day or two late with some of the 676; but the manpower that we need is shown on that chart.

We escaped a very serious problem, Mr. Chairman, this year, because Gramm-Rudman had a military personnel exemption. It did not require us to make reductions in military personnel. It allowed us to safeguard that particular program. We used it to the greatest extent we could.

We do not have it next year. If we had not had it this year, we would already have had to dismiss, last week, 280,000 people from the active duty force, and that would have been a very severe loss, and it would certainly have had a very severe effect on the economy, although that is not the reason we in the Defense Department are concerned.

We are concerned about it as to what it would do to our force strength. Now we do not have that next year, and if the Gramm-Rudman trigger is pulled next year requiring these automatic reductions right across the board, with no military personnel exemption, we will have to let go upwards of 300,000 people, and probably more, all at once, without any kind of opportunity to say that people are our highest priority, as indeed they are.

So we do have quite a lot to worry about on that, and we are concerned about it. We have extraordinarily good figures with respect to the way the All-Volunteer Program is working. This chart shows just a couple of the aspects of that. [See chart 13, p. 180.] The quality of the people coming in. The high school diploma graduates are now at 93 percent and have been for 2 years. Ninety-nine percent in the Air Force; slightly lower in the others, and this compares all the way back with 68 percent in 1980, and lower in previous years.

We also have a growing record of first-term reenlistments which pleases us very much. There is some slippage there this last year, going down from 51 percent, the first-terms reenlisting, to 47 percent. We worry about that a bit, but we still have very large pools of people who want to get in, who still have to wait in line to come in the service, and we are still getting extraordinarily good people. At least half of them want to stay there.

RETIREMENT SERIOUS PROBLEM

We have another serious problem that I should call your attention to, Mr. Chairman, with respect to the retirement.

As you know, the Congress, last year, directed us to take $2.9 billion out of our military retirement funds, and said that we could only transfer them back in if Congress enacts retirement legislation. They have to enact it by May.

If they do not enact it by May, and if the caps are not lifted on the use of those accounts, then we will have to let go right after May, and between May and the end of the fiscal year, 330,000 active personnel and 176,000 reserve spaces. This is not Gramm-Rudman or anything else. This is the retirement problem because the military personnel accounts are capped until Congress acts on retirement legislation, or until they lift the caps, and so we urgently request that you look at that problem and take necessary actions so that we do not have to put that many people out of the Armed Forces in a very sudden way, and reduce our security at a time when we need to increase it by at least 12,000 to 14,000, rather than putting 330,000 out.

GREAT DEAL ACQUIRED WITH FUNDS

We have done a great deal of modernization. The question is asked as to whether we have acquired anything for our funds that have been expended. We have acquired quite a great deal.

This is a chart that shows the contribution the reserves make to the total force, and it shows that we are not only relying on them for a very major contribution, but that we have increased funding for both guard and reserve units. [See chart 14, p. 181.]

This chart shows the fact that we are giving some very major new equipment to the guard and the reserves to make them as effective as we can, because they are, indeed, a very vital part of the total force. [See chart 15, p. 182.]

This chart shows some of the things we have acquired, contary to some of the statements that have been made, over the past few years. [See chart 16,p. 183.] In 1980, we had 34 of the M-1 tanks. We have now 3,000 on hand. We have had an additional 1,956 approved by the Congress, authorized and appropriated. And, we will put in the budget this year for another 840 M-1 tanks. So that is certainly one thing that we have acquired that has given enormous strength to the forces that we have all over the world, particularly in NATO.

The same is true of the Bradley fighting vehicle and with helicopters. It was said by some that you have no more helicopters than you had before. We not only have a great many more than we had before, but they are much better helicopters than we had before, for instance, the Apache and the Blackhawk, and we have a great many more air defense missiles, and MLRS, joint NATO program, as shown in the last line.

The same is true with the Navy, where we have added 18 new SSN-688 class submarines between 1980 and 1985. [See chart 17, p.

184.] We have 24 more that have been authorized and paid for and have some unobligated balances because the bills have not come in. We have four more in this budget, instead of the eight that the Navy wanted, and that plays out all the way across the chart. Those are submarines. The Aegis ship which is one of the best defense ships, the ships that give us the ability to defend a whole battle group. There are five more funded in this year's budget. The Trident II missile, the new missile, the D-5, will start delivering in this current budget, if it is authorized and approved. Sidewinder, Sparrows, all shown on the chart. This chart is the Air Force modernization that has taken place over those same periods of time. [See chart 18, p. 185.] So that there are very impressive gains in what we have obtained, and the fact that it is new and modern equipment of high technology, yes, taking advantages of our strong suit which is a very high technology.

B-1 BEING DELIVERED

These are the conventional forces we have obtained as well as the things we have obtained on the strategic side, where we have the B-1 coming on now after many cancellations, and many delays, it is being delivered on time, and under budget, and we have put in no more money for the B-1, because that program is finished.

You have authorized and appropriated the hundred B-1 bombers we wanted, and we do not ask for any more. We are moving now with the advanced technology bomber, which will give us an even greater capability.

We have also added the D-5 missiles, as I have said, and we have 50 of the MX missiles approved. We will ask for another 50 when we have a recommendation to make to the Congress with respect to a basing mode that we hope you will find acceptable.

Special operations forces. [See chart 19, p. 186.] We have added substantially to these, as we have had to, because of the conditions that we face in the world with terrorism, and low-intensity conflict. We have a great deal of joint operation of these in joint training, and a lot of equipment that is produced jointly by the services that has made them enormously stronger, and even more so if the 1987 budget is approved for their peculiar and particular talents that we have to have.

Here are some of the major research and development programs that we have which we hope will keep this kind of, leading edge that we need in the future. [See chart 20, p. 187.] As you see, the Strategic Defense Initiative, the President's highest priority, is requested at $4.7 billion.

We were cut $1 billion in it last year. We want to keep the momentum up of doing that program in a way that will enable us to see if we can have the thoroughly reliable defense the President envisions as soon as possible, and we think we can.

There are a lot of other items on that list of RDT&E that are vital, in order for us to keep the kind of lead we have in this one area, since we are so heavily out-numbered on the conventional and the manpower side.

MUNITIONS SUSTAINABILITY INCREASED

We have had a great deal of increased training as well as munitions sustainability. One of the key indicators of readiness as this chart shows is the additional increase in ammunition, and the munitions sustainability that we have had to acquire with major percentage increases. [See chart 21, p. 188.] With the Marine Corps, for example, there has been a 200 percent increase in artillery and air defense ammunition.

With the Army, we have experienced a little over a 125 percent increase. Others are as shown on the chart. This is, a prime part of readiness and sustainability. It is an expensive item, but not a particularly glamorous item which is an absolutely vital item. We have spent a lot of our money on this because it had to be a very big priority.

And now, training improvements. [See chart 22, p. 189.] Shown are the ways we have been able to increase the training, the exercises, the sorties, the batallions rotating through the very fine National Military Training Center that we opened at Fort Irwin.

All of these are things that demonstrate that we have, as a very high priority, readiness and sustainability of the troops.

This is one of the things we have done to expend the funds that Congress has appropriated; one of the things we had to do which has helped us most.

COST GROWTH OF MAJOR WEAPONS SYSTEMS DOWN

I have talked a lot about acquisitions and I mentioned those figures at the top, earlier, because I wanted to get that out at the beginning of the hearing in response to the point that Senator Chiles had made, and that is the cost growth of major weapons systems. It was running 14 percent at the end of calendar year 1980; they had been running as high as 17 percent before that. [See chart 23, p. 190.]

It is now down to less than 1 percent for 1983 and 1984, and it will be about the same in 1985. Multiyear procurements, which the Congress authorized in 1981, have enabled us to make major savings, $6.2 billion between 1982 and 1986, although we had to cancel some in 1986. Three are seven multiyear programs in the budget before you that will produce $2.1 billion in savings, over the years of the development of those contracts.

And the next figure shows the figures that I had mentioned previously about the increase in competition. Seventy-two percent, now, of all contracts are competitively awarded as against 40 percent when we got here.

BILLIONS BEING SAVED

Spare parts acquisition initiatives, after all of the audits, and all of the wild stories, no one has bothered to print the fact that these initiatives of our own, will result in savings of over $2.5 billion. Economic production rates have already saved $2.7 billion. This is what we want to keep on, and requires some of the larger requests for authority that we have made at the beginning. That is the only way you get them, is to enable you to have that kind of saving.

These are the efforts we have made through both our audit and our inspector general, and these are the savings that our auditors tell us we will make: $8.1 billion because of contract audits; another estimate of $2.7 billion because of the internal audits of our activities through the inspector general, and through the Defense Investigative Service, and others—recoveries and restitutions of about $126 million. [See chart 25, p. 192.]

Those are the points that I think should be before you, Mr. Chairman, and members of the committee. It is also vital that we recognize, again, that what we seek is a situation in which we do not have to reach the adverse effects of Gramm-Rudman, in which that trigger need not be pulled.

The budget that is before you is a budget that provides increases for a great many activities of the Federal Government. It allocates a little less than 27 percent of the budget to defense. It does not require a tax increase; it does not require any use of the Gramm-Rudman trigger because we reached the deficit target of that act; and it is essential that this budget be adopted.

I would like to emphasize again, my agreement with Senator Chiles, that real growth and top lines, and all of those figures are indeed a preoccupation with what is not, in any sense, a useful measure. The only important things are: What are the risks we face? What are the risks we are willing to take? What is the requirement that is needed to meet those risks? That is in the budget that is before you. Thank you very much, sir.

Chairman DOMENICI. Thank you very much, Mr. Secretary. Admiral. First let me say, Mr. Secretary, the remarks that you had prepared, which you did not give, to the extent that they are in writing, they will be made a part of the record.

[The prepared statement of Secretary Weinberger follows:]

STATEMENT OF
THE SECRETARY OF DEFENSE
CASPAR W. WEINBERGER

BEFORE THE
SENATE BUDGET COMMITTEE

IN CONNECTION WITH
THE FISCAL YEAR 1987 BUDGET FOR
THE DEPARTMENT OF DEFENSE

FEBRUARY 6, 1986

Introduction:

This is the sixth time I have appeared before the Congress to present the Administration's request for resources to ensure that the national security interests of the United States are protected. During the previous five years, the Congress and the Administration have shared the common goal of rebuilding our defenses to reestablish the balance of military power necessary for secure deterrence.

The product of that shared commitment has been impressive. Together, the Congress and the President have restored national pride, and international respect for the United States. The quality of the men and women in the military today has never been higher. American forces around the world are ready to respond to aggression. We are succeeding in getting large quantities of weapons deployed to our forces.

The political effects of this shared commitment are also evident. American resolve to resist aggression is evident; our alliance partnerships are stronger; and, an unwilling Soviet Union has been forced back to the arms negotiating table in the grudging realization that it will not be allowed to achieve military superiority over the United States and our allies. Further, the sequence of annual Soviet aggression against new targets that began in the mid-1970s with Angola, and culminated in the brazen invasion of Afghanistan, has ceased. Working together, the President and the Congress have come far in reversing a decade of neglect, restoring the deterrence balance, and updating our defense strategy and policy.

These are powerful and direct results of American resolve and commitment to bear the cost security requires. The responsibility to sustain these results lies before us as a continuing requirement. It is obvious that the FY 1987 defense budget represents a critical phase in the continuation of our shared goals and responsibilities. Shall we maintain our goal of rebuilding U.S. defenses or will we fall back and see this effort falter? The Administration remains committed to the sustained improvement of U.S. national security capabilities. But that goal is threatened as the Congress' commitment to the priority of national security wavers.

Few dispute the risks we face today. Soviet military capability grows unabated as it moves to confront the United States throughout the world. Risks to regional stability abound -- even here in our own hemisphere. While the strategic and conventional challenge to our security continues, terrorism and low intensity conflict have emerged as additional risks with which we must contend. Yet, in the face of this situation, some individuals maintain that our defense efforts must now be relaxed -- not because the risk is diminishing, not because a modern and responsive military capability is unnecessary, but because it is asserted that the United States cannot afford an adequate defense.

I have never accepted this assertion, nor the peculiar belief that American politics require that military preparedness must suffer in equal measure with dams and mass transportation projects in times of fiscal constraint. Those who argue that we should forego a significant increase in safety must explain why.

The central questions each of us must ask are:

1. Are we, for any reason, prepared to cut American strength in ways that increase the risks of war? Those who judge that, in order to reduce the Federal deficit, the United States should underfund the program previously agreed to by the President and the Congress and run higher risks to our security should stand up and say so.

2. With arms reduction negotiations ongoing and the Second Summit near, is this the time to tie the President's arm behind his back, rather than strengthening his hand? Make no mistake, the critical variable in the Soviet Union's willingness to negotiate seriously, to accept reasonable agreements, and to comply with those agreements, is their judgment of what we will

do, if they don't. Who is prepared to take responsibility for undermining the Soviet Union's incentive to accept an agreement for real reductions in strategic nuclear arms?

3. Is America not safer than we were five year ago? Does anyone want to go back to the U.S.-Soviet relationship of the late 1970's? Is American strength not the price for peace?

Budget Realities and Defense Spending:

I fully appreciate the fact that we are preoccupied with deficits. I understand the pressures confronting the Congress. Controlling deficits by reducing those areas of Federal spending which are improper or unnecessary is a goal I have always supported. Consequently, the Department of Defense has striven to take advantage of every opportunity to hold down defense costs through good management and contracting. In this regard I believe that defense has a good record if anyone will look at it.

Defense and Deficit Reduction:

Defense spending has been a continual contributor to deficit reduction exercises. Since transmittal of the President's FY 1985 budget in January 1984, defense budget authority and outlays have been reduced by $328.7 billion and $291.1 billion, respectively. Good management and the President's success in controlling inflation have enabled us to preserve force modernization despite these reductions -- which have often been the only real reductions in spending the whole budget process has sustained.

There are those who seem to insist that the only acceptable evidence of defense participation in deficit reduction efforts is the cancellation of a needed defense program. The Department of Defense has been a victim of its own success in keeping programs on track while making do with less. The results of better management have been labeled as proof of waste and overbudgeting by those who would rather see public support for the President's defense initiatives fail.

The defense budget has become the target of opportunistic demagoguery, and our security has suffered. Prior to the application of the Gramm-Rudman cuts, the FY 1986 enacted defense budget represented a $24 billion reduction from the President's request. After absorbing the additional Gramm-Rudman-required reductions of $11 billion, the FY 1986 defense budget will represent a 6.2 percent real decline - the first time in 15 years that there has been an absolute decline to the defense budget below the previous year. One looks in vain to discover just what reduction in the risks we face occurred last year to justify this approach.

FY 1987 Department of Defense Budget:

Nonetheless, the Department of Defense (DoD) is keeping faith with the 0-3-3 percent real growth budget plan which the President and the Congress negotiated and which the FY 1986 Budget Resolution specified for national defense; just as in previous years we have conformed our requests to congressional agreements.

The President is requesting $311.6 in budget authority (BA) and $274.3 billion in outlays for the Department of Defense in FY 1987. The FY 1987 defense request is consistent with the goal of controlling federal spending as reflected in the agreement between the Congress and the President. In fact, the defense topline of $311.6 billion for FY 1987 is well below the $314.7 billion target specified in the budget resolution.

The size of the defense topline must be considered, of course, in the context of the total fiscal picture. However, we simply cannot use topline real growth rates as a yardstick for defense budgeting. In the final analysis, the Department of Defense does not have to spend a particular amount of real growth, but it does have to fund real programs to meet real risks.

The proper level of defense resources cannot hinge on snapshot calculations of real growth based on rapidly changing and arbitrary economic assumptions. The Congress must also look carefully at the programs being purchased. It must assess the priority of the defense program as an element of federal spending and the priorities of the programs within the defense budget. That is the way the Administration has developed the defense request and how the Department is ready to defend it. Unfortunately, there has been an increasing tendency by some in the Congress to refuse to address defense priorities and only want to deal with the defense topline.

Congressional Action on the FY 1986 DoD Budget:

Frankly, this approach makes a travesty of both the Administration's efforts to develop a budget that conforms to the latest available congressional direction, and the congressional efforts to review and adjust it to reflect its own priorities. Last year, for example, the Armed Services Committees spent many months enacting a bill that reduced the President's FY 1986 defense request by $19.2 billion. This was difficult work, but it did produce a defense program reflecting congressional priorities for a budget that size.

The problem is that the Congress subsequently decided that it didn't want a budget that size, but one $5 billion lower. That budget was enacted in the Continuing Resolution. Then came the Gramm-Rudman legislation and another $11 billion reduction, for a total reduction of $35 billion from the President's request. So, in the end, the Congress did not provide even the zero real growth in defense spending which it had endorsed only three months earlier, but instead a 6.2 percent decline.

America's defense posture requires a stronger commitment from the Congress than this; a commitment to return to a solid and consistent budget plan for national security resources. The Congress must decide whether we are going to budget for what we need in defense, as measured by the increasing risk we face, or whether we are going to squander past gains and return to the practice of regarding defense spending as the balance wheel of fiscal policy -- a practice which gave us the hollow forces of the 1970's.

New investment programs represent only a little more than one-tenth of total defense spending planned for FY 1987. Therefore, imposed reductions will threaten readiness efforts, pay and end strengths, and existing prior year contracts.

Neither the Department of Defense nor anyone else can manage a rational or efficient modernization program when budget resources change unpredictably from year to year, much less so when they do so from month to month, long after the fiscal year they affect has commenced. Program managers and military leaders have nothing on which to plan when budget levels constantly shift under their feet.

The Administration is presenting a sound defense budget for FY 1987. It is consistent with the Congress' own budget plan of a few short months ago. It builds upon the results of the resources the Congress has previously provided for defense. It continues the initiatives of the past four years. Its objective is to complete and sustain the efforts and improvements already realized. I urge the Congress to get the defense debate back on track by considering the FY 1987 defense budget request in terms of the priorities upon which it was built, and the risks we face from ever growing Soviet military strength.

Confronting Soviet Capabilities:

Development of our defense program and budget begins with an assessment of the current and projected risks to U.S. national security. In this respect Soviet military capability remains the dominant consideration.

The Soviet modernization program, which started several years sooner than ours and at a faster pace, continues unabated. The Soviet Union is aggressively acquiring a military force capable of accomplishing its stated goal of extending Soviet control and dominance throughout the world.

As a result, several military power balances long favorable to the United States have begun tilting in favor of the Soviet Union. Gorbachev's ascension to the post of General Secretary has brought about greater public posturing on issues vital to East-West relations in an effort to project a more positive image. And, while Soviet public relations may have undergone a cosmetic improvement, Soviet military growth continues with new strategic and conventional systems being fielded, and even more advanced systems under development or in various stages of research. The Soviet military, of course, will continue to receive strong support from the new leadership, and to enjoy its place of prominence in the allocation of resources.

Our security strategy is to build the strongest possible deterrence. We seek to protect our interests and those of our allies by preventing war. We seek to accomplish this by convincing potential adversaries that the costs of attacking us would far exceed any gain they could hope to achieve.

We do not, nor could we, seek to create a credible deterrence alone. In Europe, NATO continues to maintain a credible capability to deter a Warsaw Pact attack. In Asia, the military balance favors the Soviets, but with our current modernization programs the long-term trend favors us and our Asian allies and friends. The ability to project our power still favors us, but we must continue to monitor carefully Soviet programs enhancing their force projection capability.

NATO and Warsaw Pact Forces:

The Soviets have achieved an overall quantitative advantage in conventional weaponry. Further, the quality of their weaponry has improved significantly, often as the direct result of purchase or theft of western technology. Finally, the Warsaw Pact allies have created a military force that far exceeds one necessary to defend their territory.

Certainly there is not the slightest indication that a reduction in our commitment to invest in our military forces will result in a corresponding reduction by the Soviets and their allies or an abandonment of their strategic objectives. The evidence of the past is quite to the contrary. Indeed, if the United States were to devote the same percentage of its GNP to its military as the Soviets do, we would not be submitting an FY 1987 defense budget of $311.6 billion, but of some $700 billion.

FY 1987 Defense Program:

The United States must sustain the long-term program for rebuilding strength adequate for secure deterrence. If peace seems expensive, consider the alternative. By scrimping on strength, we can reduce our security and increase the risks of war. But if we fail to keep the peace, the cost to our standard of living, indeed to our lives and our country, would be incalculable.

The FY 1987 program is intended specifically to address the risks confronting the security of the United States within the fiscal constraints established by the Congress in the budget resolution last year.

The FY 1987 DoD budget reflects a reevaluation and revalidation of our basic force requirements. It is built upon the same force goals and continues the same modernization programs which the Congress has approved over the last four years. The only changes are further efforts to employ greater procurement economy and efficiency to achieve these goals in the most expeditious fashion.

Defense Manpower:

Active Duty Personnel

No turnaround these past five years has been more remarkable than the improvement in personnel quality and retention throughout all components of the military Services. The FY 1987 budget requests $76.8 billion for military personnel costs.

Of this amount, $67 billion supports the active duty personnel. Active force end strength is programmed to increase by an additional 14,000 in FY 1987. The majority of this increase, 11,400, supports the Navy's active fleet, which goes from 553 ships in FY 1986 to 566 in FY 1987. The growth in end strength will provide manning for new ships and squadrons and other direct fleet support requirements.

An additional 1,500 increase in end strength is requested for the Marine Corps to support continuing Fleet Marine Force improvements, highlighted by the addition of a Target Acquisition Battery, conversion of aircraft squadrons to AV-8B, F-4, and F/A-18 aircraft, and the activation of a ship's detachment for the USS Wisconsin.

Recruiting and Retention

While we continue to maintain favorable recruiting and retention levels of high quality personnel, some figures this year in retention raise concerns about our future ability to compete successfully in an increasingly favorable economy.

To counter this reversal, the FY 1987 budget continues our support for adequate compensation and an adequate basic standard of living for all our servicemembers.

Although budget constraints have kept military pay raises at a modest levels during the last few years, the Administration remains committed to the principle of pay comparability and strives to maintain an overall military compensation program that can compete with other employment alternatives. Therefore, the current budget request proposes a 4 percent military pay raise effective October 1, 1986, which is comparable to anticipated private sector wage increases and prevents further widening of the pay comparability gap, currently estimated to be 8.3 percent.

Retired Pay

The FY 1986 Department of Defense Authorization Bill directed the Department to submit legislation to achieve a $2.9 billion savings by changing the military retirement system for new personnel entering the Service. The FY 1986 Appropriations Bill deleted the $2.9 billion from our budget but provided authority to transfer up to $2.9 billion of prior year balances back into these accounts to cover the higher costs we will incur until the Congress enacts the retirement changes. However, the Appropriations Act provides only temporary relief to the Department since it requires that, after May 1, 1986, we must revert to the obligation limits imposed by the Authorization Act. Legislation to change the retirement system and to lift the obligation caps was submitted to and is currently being considered by the Congress. If retirement reforms or relief from the obligation caps are not enacted, the Services would have to reduce military personnel by over 330,000 active and 176,000 reserve spaces.

Reserve Components

The increasing role of the Reserves demonstrates the success of our Total Force Concept. As a percentage of total forces, the Reserves are making a significant contribution.

The budget includes $9.8 billion in support of the Reserve components and reflects an increase of 52,000 end strengths for the Reserve and National Guard components. This increase will allow the Army Reserve to reach the goal of 90 percent trained-in-unit strength in FY 1987 and support 105 unit activations and 70 deactivations.

The Reserves continue to receive our most modern equipment and weapon systems. These include M-1 tanks, Bradley Fighting

Vehicles, AH-64 Apache and UH-60 Blackhawk helicopters, KC-130T tanker and C-130H cargo aircraft, as well as F-16 fighters.

The role of the Naval Reserve Force (NRF) continues to increase. In FY 1987, the first of two reserve squadrons of airborne mine countermeasures helicopters will be established. Eventually, all of our new MCM 1 mine countermeasures ships will be operated by the NRF, as well as an increasing number of amphibious assault and support ships.

Civilian Personnel

The budget reflects an increase of 4,400 civilian end strengths to provide for a wide range of programs and activities. This increase reflects the emphasis being placed on our efforts to improve the acquisition of weapons through improved contract administration and audits. The FY 1987 budget requests a 3 percent pay raise for the civilian workforce, effective January 1, 1987.

Modernization:

Strategic Forces

The FY 1987 budget continues the President's commitment to modernize and improve all aspects of our strategic forces in order to ensure a stable deterrent and create a favorable atmosphere for arms reductions talks. Funds are requested to purchase 21 MX test missiles and for research on new basing modes. In keeping with recent congressional limitations, we plan to place only 50 MX missiles in existing Minuteman silos. We are also requesting funds to begin full-scale development of a new small ICBM.

An additional TRIDENT nuclear submarine is requested as well as the initial procurement of 21 TRIDENT II (D-5) missiles, the first U.S. sea launched ballistic missile capable of retaliating effectively against hardened Soviet targets.

Research and development funding is requested for the continued development of the Advanced Technology Bomber and two new bomber-delivered weapons, for the advanced cruise missile, and for the short-range attack missile. No funds are requested for further procurement of B-1B bombers. That program has been completed below budget and ahead of schedule. The B-1 program remains as a model of how efficient defense acquisition programs can be if they are executed as planned.

Conventional Forces

In the area of conventional forces, we continue to place emphasis on maintaining modern forces that are properly equipped, adequately supported, and carefully balanced between active and reserve components and between the United States and allied capabilities.

Our inventories are making substantial gains as the Army maintains its force level of 18 active and 10 reserve divisions. The FY 1987 budget continues our investment in our land forces by requesting 840 M-1 tanks, 870 Bradley Fighting Vehicles, and 144 AH-64 Apache helicopters.

The FY 1987 budget supports the goal of a 600 ship navy by FY 1989, 15 carrier battlegroups and 4 battleship battlegroups. The budget reflects the procurement of 5 AEGIS ships; 2 CG-47 cruisers and 3 DDG-51 guided missile destroyers. Acceleration of the Navy's F/A-18 procurement, with procurement of 120 aircraft in FY 1987, demonstrates our commitment to achieve our inventory goals for this critical fighter/attacker.

The budget commits the necessary resources, beginning in FY 1987, to achieve the 40 tactical airwing goal, up from our current 37. This is reflected in the procurement of 48 F-15 and 216 F-16 fighter aircraft for the Air Force. FY 1987 marks the completion of procurement of 50 C-5B airlift aircraft.

Supporting the modern weapon systems being obtained by our forces are continuing procurements of strategic and tactical missiles. The Army is procuring 700 Patriot and 4,180 Stinger missiles in support of its ground forces. The Navy and the Air Force are procuring an additional 2,337 Sidewinder and 2,095 Sparrow missiles for their tactical forces. And, the Air Force continues procurement of Ground Launched Cruise Missiles (GLCM), with an additional 76 planned in FY 1987.

Emphasis continues to be placed on our Special Operations Forces (SOF). To ensure that we achieve the high state of readiness required for the Special Operations Forces to meet their key role of contingency response, the FY 1987 budget reflects a variety of modernization and expansion efforts.

Procurement of 5 modern transport and reconnaissance MC-130H airlift aircraft will provide modern avionics and electronic countermeasures capabilities, as well as an all-weather capability to transport troops in covert military operations. The budget also supports the development of materials for use by Army SOF aircraft in areas of Terrain Avoidance Radar, engine upgrades, and integrated cockpits.

Research, Development, Test & Evaluation:

Resources provided for research and development are of particular importance because they represent investment in future military capability.

As the President's highest priority effort, we are vigorously pursuing experiments and demonstrations to assess the feasibility of Strategic Defense Initiative technologies to support development decisions planned for the 1990s.

The LHX will replace the Army's aging inventory of lightweight combat, utility, and observation helicopters with a new technology, cost-effective rotorcraft. Further, we are actively exploring gun/missile combinations and new sensors to provide our forward area troops with an effective short range air defense capability now that we have cancelled the DIVAD program.

In an effort to assure that we can meet the air-to-air combat threat of the 1990's and beyond, we are investigating the latest technologies in fighter avionics and engines.

We are at the peak period in the development and testing of the JVX tilt-rotor aircraft which will drastically cut the exposure time for Marines as they perform their vertical assault mission.

And, development is well underway for a faster, quieter, attack submarine and its advanced combat system to maintain our relative capability against the latest Soviet submarine class.

Readiness and Sustainability:

In addition to manning and modernizing the force, we have placed a high priority on continuing the marked improvements made over the last four years in the sustainability of our forces. Special emphasis has been placed on the acquisition of sonobuoys, due to the important role they play in the early detection of enemy submarines, and to increases in surface-to-surface missiles, such as Tomahawk and Harpoon.

The progress achieved in the inventory levels of our munitions is truly a success story. But, these are the very types of successes that will be the first to turn into shortages under successive Gramm-Rudman sequestrations, since there is no possibility, under the law, of choosing any priorities.

Training Improvements

Given the quantitative advantage of the Warsaw Pact nations in munitions and weapon systems, the Navy and Air Force have emphasized increased training, through higher levels of flying hours and steaming days for our airmen and sailors, in order to use our munitions more effectively and efficiently. The Army has increased the rotation of battalions through the National

Training Center. These efforts now, at last, compare favorably with the training provided our adversaries. And, in FY 1986, we will be conducting 86 exercises in cooperation with 45 countries.

As we have increased our training and operating tempos, we have increased the need for maintenance and logistic support. Increased unit, intermediate and depot-level maintenance requirements are provided for in the budget.

With this budget, we will be able to maintain the readiness and sustainability improvements made to date and make modest further improvements in the ability of our forces to accomplish mission objectives. But we will not be able to maintain these improvements in readiness and sustainability if this budget is cut by congressional action or Gramm-Rudman sequestration, or both, as happened this year.

DoD Management:

Good management is the third major priority upon which this defense budget is based. There is more accountability within the Department than ever before. We are controlling cost growth. The cost growth for 84 major weapons systems was 1 percent or less for the two recent years. Compared with an annual cost growth over 14 percent in 1980 and many prior years, this is a major achievement.

What product is the American taxpayer buying today for less than we paid in FY 1982? The B-1B bomber, F/A-18 fighter, and AH-64 helicopter to name but three major weapon systems that are being bought for less today than we were paying when this Administration entered office. The secret of this success can be summarized in two words: competition and management. Since 1980, the number of competitive contract actions has increased by 37 percent, so that today more than two-thirds of all contract actions have been awarded on the basis of competitive bids. Management that demands performance has reduced cost growth, increased quality, and kept programs on schedule.

Repeated incomplete and erroneous reference to a few widely published items should not always be allowed to obscure the facts, and the facts are that the Department's management, with measurable results, is vastly improved. Additional details on these improvements are set forth below.

Auditing capabilities have been significantly improved and this request takes that further.

I hope the various outside studies now underway will take due note of the Department's successes in procurement in recent years, for the successes truly point the way to even better management in the future.

Acquisition Improvements

We have reduced the cost of our major weapons systems, delivered them on or ahead of schedule, improved the quality of those systems, and built up the industrial base to accelerate production should it be necessary in the future. These accomplishments were made, in large part, through wider use of competition, multiyear procurement, economic production rates and through stable procurement plans. The B-1B and M-1 programs are two notable successes in this regard; as well as our shipbuilding and aircraft programs and many others.

The total number of annual competitive contracts has increased by 37 percent to over 6 million contracts since FY 1980. In FY 1985 nearly 72 percent of all contract actions, amounting to $105 billion, were awarded under competitive contracting. Competition in shipbuilding has increased from 26 percent in FY 1981 to approximately 90 percent at the end of FY 1985. Currently, there are 44 major Department of Defense systems and subsystems that are dual sourced. Many of the remaining sole source programs are essentially follow-on contracts, awarded to the winning bidder after competition.

Savings from multiyear procurement and economic production rates are projected to be over $11.0 billion since 1982. While the dollar savings from these programs are substantial, an equally important benefit is the improvement in quality of weapons and the increase in the industrial base. These benefits flow from a stable work force, dual sourcing, and competition among subvendors associated with economic order quantity procurements and economic production rates.

Improving the Department's procurement and acquisition process has been a particular priority of mine. Additional people have been added to staff increased Department of Defense competitive procurement and to improve price surveillance. These efforts have reduced prices across the board. Under this program we have reviewed 250,000 items and designated 54,000 items for full and open competition. We identified another 51,000 items for purchase from the manufacturers, thereby eliminating "middle man" charges. We have documented spare parts savings in excess of $2.5 billion in FY 1984 and FY 1985. These initiatives have helped reduce the trend in spare parts spending by $11.1 billion from our projections in FY 1984.

We are pursuing management improvements whenever and wherever we can. And, while there is much that can be accomplished solely within the Department, we have made it clear to the defense industry that they, too, must be part of the solution.

The private sector has responded well. Some of our major suppliers have established their own spare parts awareness programs to get ideas from their employees on ways to keep costs down and improve quality. Contractors are voluntarily identifying items for competition or direct purchase from the actual manufacturers. And, many of our larger manufacturers are offering the best no-fault refund policy there is. It is simply this: if the Department thinks an item has been overpriced, the item can be returned for full refund.

Efforts to Stop Waste, Fraud, and Abuse

Still, we do not and cannot rely entirely on the goodwill of industry to prevent abuses. We have suspended or debarred more than 1,400 defense contractors since 1981. Where there has been serious fraud or illegal activity, we have sought criminal indictments from the Department of Justice not only against the companies involved, but also against individual employees and officials who abused their trust.

Further, under this Administration, we have initiated the most comprehensive set of audits and investigations in the history of DoD. To monitor and control prices, we are continuing our aggressive audit efforts. During FY 1985, the Inspector General issued 125 audit reports that identified $1.1 billion in potential monetary benefits. Potential monetary benefits from all other DoD audits and reviews, including Service audit agencies and internal reviews, increased the total to $2.7 billion.

Department of Defense worldwide contract audit activities are conducted by the Defense Contract Audit Agency (DCAA). DCAA audit services result in over 60,000 audit reports annually. These audits have produced an estimated savings of $8 billion in FY 1985. Recently acquired subpoena authority, combined with a variety of new audit products and increased resources, should strengthen this already valuable arm of the Defense Department.

Management Improvements

The Department has also successfully implemented a broad range of initiatives in cash management, debt collection, administrative systems, and management reviews. Cash management initiatives have accounted for $225 million in savings through FY 1985, and an additional $160.5 million are projected for FY 1986. We have documented nearly an 80 percent improvement in Department of Defense management controls, as measured by the Federal Financial Management Integrity Act. In another area of congressional interest, we have reduced computer leasing costs by implementing more cost-efficient purchases of ADP equipment.

We have not limited our efforts for management improvement and associated savings solely to this Department and its contractors. Since we and our NATO allies field the same weapon systems in the European theater, it makes sense to cooperate on the logistics support programs for those systems. We have joined weapon system partnerships with NATO allies for the Patriot missile and the Multiple Launch Rocket System and are actively pursuing similar arrangements for TOW and Lance. We are also working toward consolidated procurement of common NATO munitions.

Many of our allies have indicated support for SDI research and, in some cases, interest in participating. The United States and the United Kingdom recently signed a memorandum establishing the framework for British participation in the SDI program. Discussions are also being conducted with other NATO nations.

We have pursued every avenue to realize savings and efficiencies within the Department. We will continue to scrutinize defense operations, not just to see where waste and fraud is occurring, but to identify where it might occur. Such intense review should continue to be productive.

At the same time, there is a very counterproductive aspect in the current trend in congressional scrutiny of Department of Defense management. It is alarming to see an issue as important as the proper level of American defense preparedness hanging on questions such as whether departmental practices have resulted in over payment for a hammer or an airplane toilet seat as if a system of zero errors were the goal -- and particularly when the facts on those and other individual purchases are so distorted. It is discouraging to see some members of the Congress scrambling to publicize such instances, which have frequently been identified and corrected by the Department's own audit systems, as if they were participating in a fraternity scavenger hunt.

Such activities add little to the efforts that both the Congress and the Department already have underway and frequently detract from the important issues confronting our defense planning. They are used most frequently to distort the true picture of the defense acquisition process. As is the case in all large operations our procurement system is subject to isolated abuses and mistakes. But the important fact is that these problems are being constantly ferreted-out and addressed while the larger process continues to perform well.

We sign 52,000 contracts every single day - of course there will be mistakes. The real question is, is anything being done to predict and correct mistakes, and any objective look would conclude we have made great improvements and are continuing to do so. Objective examinations are very useful but uninformed, distorted, and continual criticism, designed primarily to cover the level of severity, can have a detrimental effect on the morale of the very skilled and experienced people, civilian and military, who manage defense procurement. These dedicated people, upon whom we rely to produce our defense capabilities, should not be used as punching bags by those who profess themselves as being "strong on defense."

The fact is that, by and large, the defense acquisition system is working. Over the past five years our forces have acquired more and better weapon systems and equipment than most people, in 1981, believed was possible within the budgets we originally sought, which were larger than defense actually received; and we are doing it without the cost growth and overruns which formerly plagued the Department.

The 1987 budget proposes to buy more program for less money than most observers would have believed possible just last year. This is largely because of our focus on stable programs and because of the acquisition reforms we have made that are working. We are seeing now the results of greater efficiency. The introduction of additional reforms where they are needed has the highest priority within the Pentagon and is a topic of constant attention.

Gramm-Rudman:

A few words are in order regarding the implications of the Gramm-Rudman law for the defense program of the United States. In Gramm-Rudman a unique step has been taken. The Congress has said that it wanted to create a club with which to beat down the deficit because your existing processes had not achieved the desired result. But a club is a very indiscriminate weapon and, unless the Congress is careful, the chief collateral effect of Gramm-Rudman may be to undermine the U.S. defense infrastructure in ways that encourage Soviet risk taking, discourage their willingness to negotiate lower levels of arms, and thus increase the dangers of war.

The additional five percent defense reduction imposed by Gramm-Rudman this year after congressional enactment of the FY 1986 budget, reduced funding for all appropriations, except Research, Development, Test and Evaluation, to levels below those in FY 1985. People who criticize reductions that affect readiness will be right, but they should know that the statute gives us no option. Readiness, of course, will be affected first as training, spare parts, ammunition, and other important support items absorb these required reductions. Procurement efficiencies will also be impacted as a result of the Gramm-Rudman effect of underfunding the FY 1986 program by five percent.

Our allies and adversaries alike will recognize that domestic fiscal pressures, more than national security requirements, are determining our budgets for national defense.

But if the Congress simply enacts the President's budget or produces a budget consistent with the President's request, it can avoid triggering a sequestering process that could literally reverse the results of the past five years, and throw defense planning into chaos. I cannot exaggerate the impact if failure to enact the President's budget triggers Gramm-Rudman.

Gramm-Rudman need not be triggered. The President has submitted a budget plan consistent with the FY 1987 deficit target. If this budget plan is not followed, however, and Gramm-Rudman is triggered in some of its more extreme scenarios, or if the Congress underfunds defense to avoid triggering, it could be the equivalent of unilateral disarmament. Moscow and our allies, who are regularly urged to spend more on defense, wait and watch with interest.

Conclusion:

I urge the Congress to get the defense debate back to the question of what this Nation's security requires. We have dwelt on terms like "real growth" and "toplines" too long and we risk losing sight of the reasons why we require a strong defense.

The Administration has made its priority choices regarding defense. The program before you is a good one. This defense budget is $3 billion below the budget specified by the Congress just a few months ago and agreed to by the President. I have yet to hear either a convincing explanation, or indeed any explanation, of why a funding level deemed necessary and affordable for national security a short time ago is now unacceptable. Surely no one contends the world has become more peaceful.

The Congress must make up its mind on this issue. No defense program, at any funding level, can function properly or efficiently, or deliver the safety required for the Nation, without consistency and sustainability and some concern for the realities of the world.

Military planners and program managers cannot be haunted annually by the spectre of a defense budget freeze or 6 percent reductions and remain effective. Neither the benefits of efficient contracting nor the required security of the Nation can be realized if we thus ignore our real needs.

The world is watching to see what the Congress determines this year. We should work together to inspire public confidence and respect for a defense program that ensures our national security. The effort to provide increased military readiness and force modernization which has yielded so much in the past five years should be sustained. The Congress as a whole should not be a party to the distortion and exaggeration about the defense program practiced by those who seemingly would prefer to see these results reversed.

In peacetime the defense budget is perhaps the single most significant statement of the United States' defense policy and objectives. We should send a strong message to friends and adversaries alike that the security of the United States is not a whim of economic statistics, but a bedrock requirement and commitment which this Nation can easily afford.

CHART 1

DOD TOPLINE REDUCTIONS

(BUDGET AUTHORITY in BILLIONS)

	1982	1983	1984	1985	1986	TOTAL 1982-1986
Amendment March, 1981	221.8	254.5	288.9	326.2	367.2	1,458.6
INCREMENTAL ADJUSTMENTS TO PLAN						
Sept 1981 through FY 1985 Enacted	-8.0	-15.0	-30.7	-39.4	-42.4	-135.5
FY 1986 Budget - Jan 1985	-	-	-	-	-11.1	-11.1
FY 1987 Budget - Jan 1986	-	-	-	-	-24.2	-24.2
PL 99-177	-	-	-	-	-11.0	-11.0
TOTAL ADJUSTMENTS since MARCH, 1981	**-8.0**	**-15.0**	**-30.7**	**-39.4**	**-88.8**	**-181.9**
Current TOPLINE	213.8	239.5	258.2	286.8	278.4	1,276.7
OUTLAY ADJUSTMENTS since MARCH, 1981	**-1.9**	**-16.1**	**-29.0**	**-51.9**	**-77.6**	**-176.5**

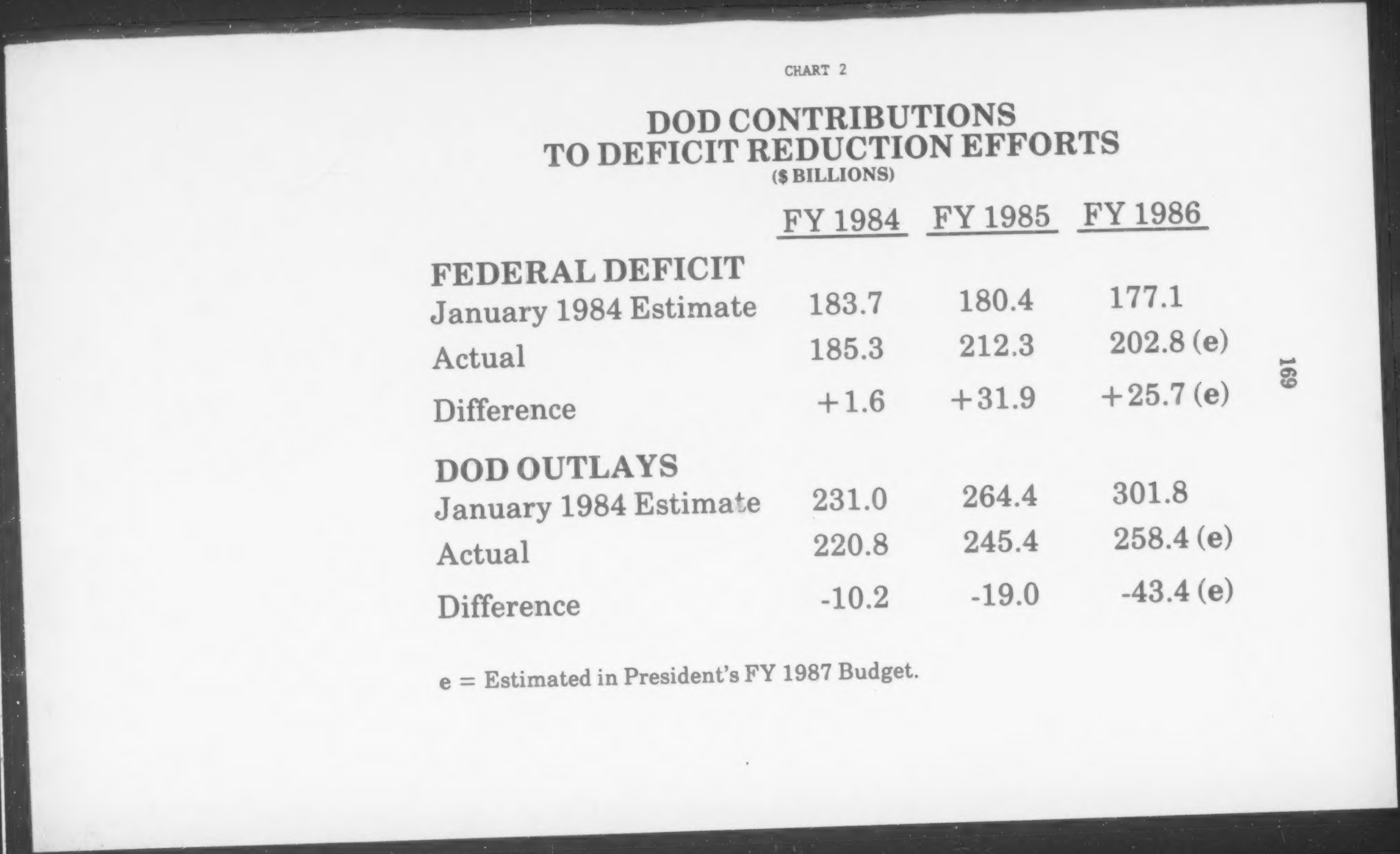


CHART 2

DOD CONTRIBUTIONS TO DEFICIT REDUCTION EFFORTS

($ BILLIONS)

	FY 1984	FY 1985	FY 1986
FEDERAL DEFICIT			
January 1984 Estimate	183.7	180.4	177.1
Actual	185.3	212.3	202.8 (e)
Difference	+1.6	+31.9	+25.7 (e)
DOD OUTLAYS			
January 1984 Estimate	231.0	264.4	301.8
Actual	220.8	245.4	258.4 (e)
Difference	-10.2	-19.0	-43.4 (e)

e = Estimated in President's FY 1987 Budget.

CHART 3

FY 1987 DEPARTMENT OF DEFENSE BUDGET

BUDGET AUTHORITY & OUTLAYS

(CURRENT $ BILLIONS)

	FY 1985	FY 1986	FY 1987
BUDGET AUTHORITY	286.8	289.4	311.6
PL 99-177	-	-11.0	-
NET B A	**286.8**	**278.4**	**311.6**
OUTLAYS	245.4	263.6	278.0
PL 99-177	-	-5.1	-3.8
NET OUTLAYS	**245.4**	**258.4**	**274.3**

CHART 4

CONGRESSIONAL ACTIONS on FY 1986 DoD BUDGET

(CURRENT $ BILLIONS)

	BUDGET AUTHORITY	
	LEVEL	REDUCTION
President's Budget Request	313.7	
(0- 3-3 % growth compromise)	[294.5]	(-19.2)
Authorization Bill	294.5	-19.2
Continuing Appropriations	289.5	-5.0
SUB TOTAL		**-24.2**
PL 99-177	278.4	-11.0
TOTAL BUDGET AUTHORITY REDUCTION		**-35.2**
TOTAL OUTLAY REDUCTION		**-19.1**

CHART 5

FY 1987 DoD B/A & OUTLAYS

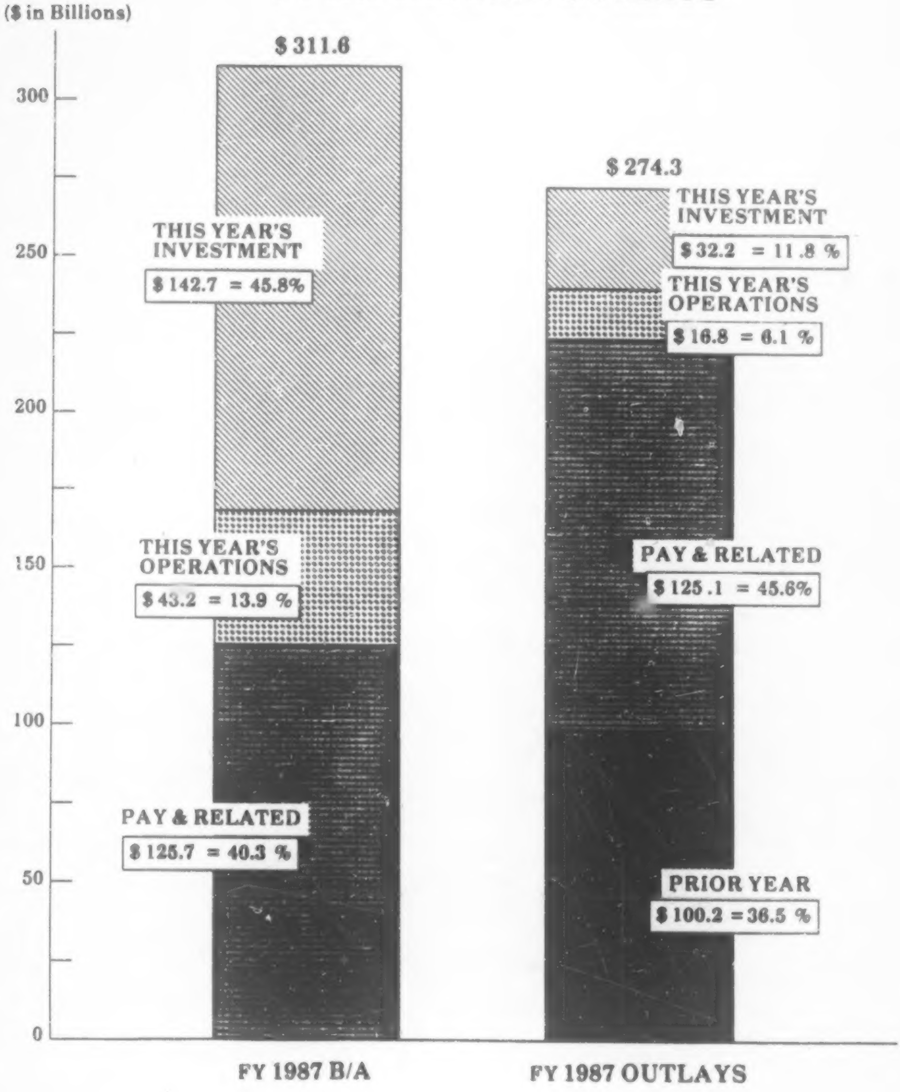


CHART 6

PRODUCTION OF SELECTED WEAPONS for NATO and WARSAW PACT FORCES

(1975 - 1987)

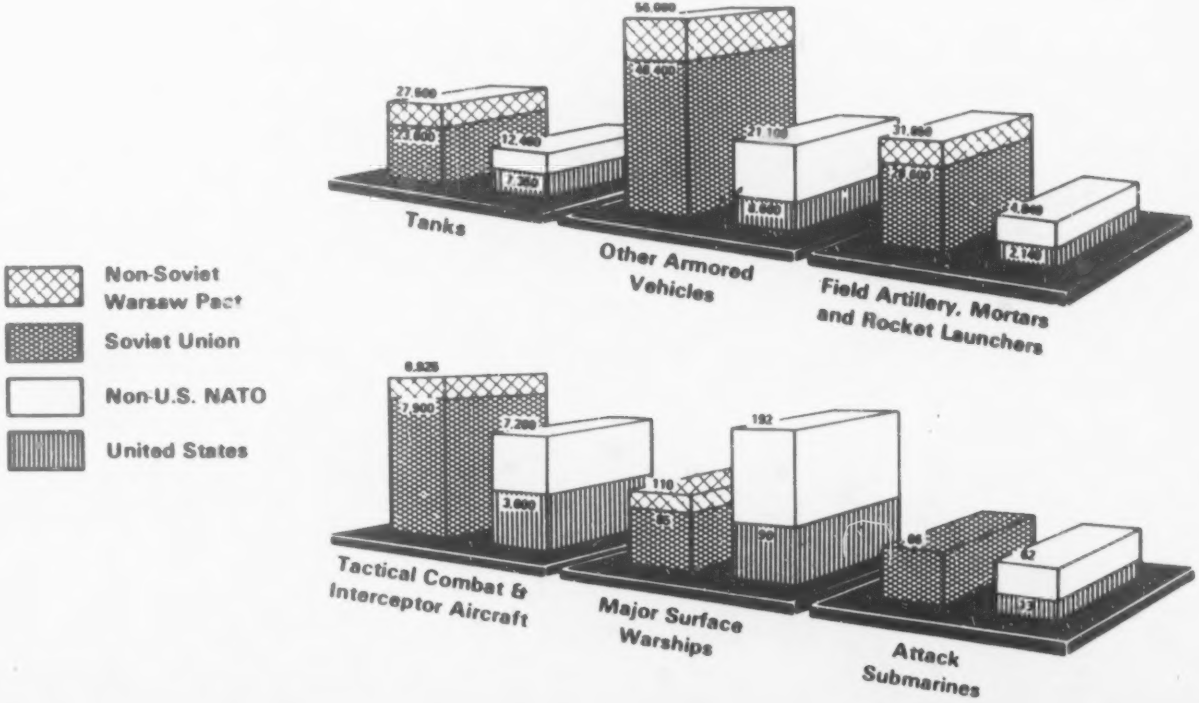


CHART 7

COMPARISON of 1981-1985 EQUIPMENT DELIVERED with FY 1987 BUDGET

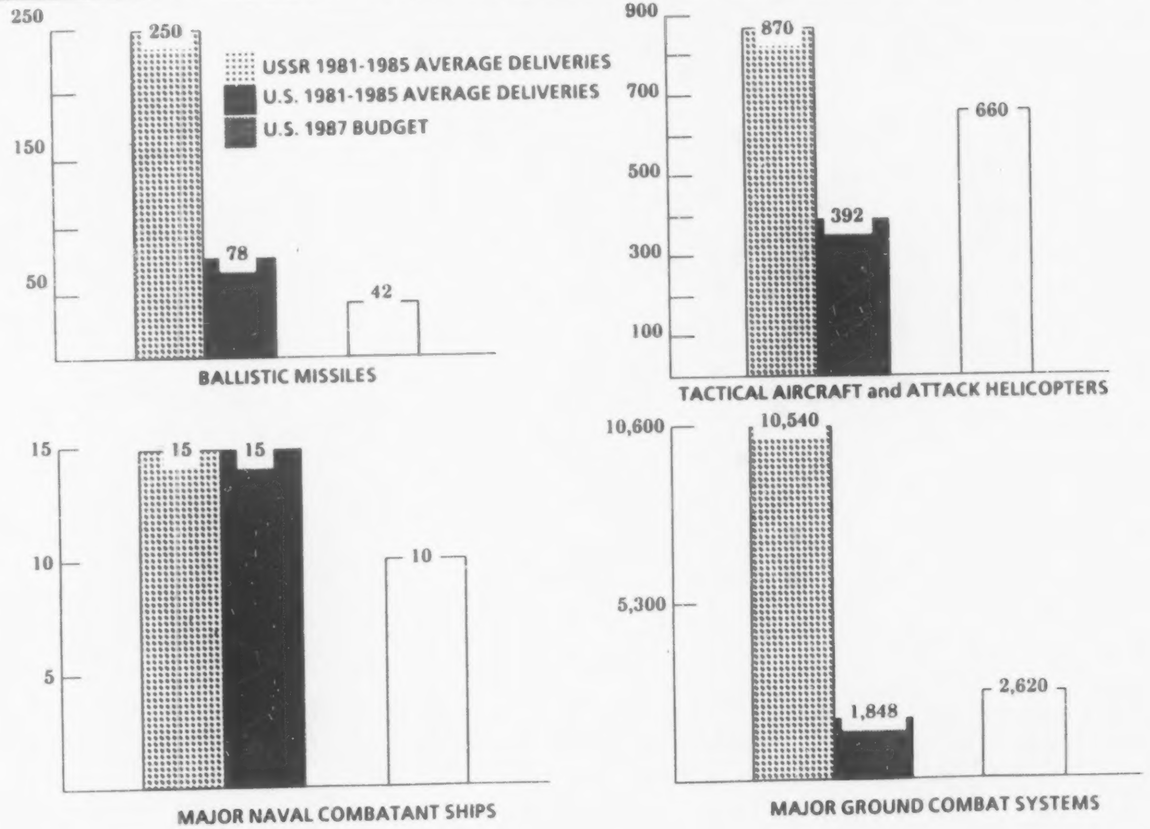


CHART 8

FY 1987 DOD BUDGET
BUDGET AUTHORITY BY TITLE
(CURRENT $ BILLIONS)

	FY 1985	FY 1986	FY 1987
MILITARY PERSONNEL	67.8	67.9	76.8
O&M	77.8	78.7	86.4
PROCUREMENT	96.8	97.3	95.8
RDT&E	31.3	35.5	42.0
MILITARY CONSTRUCTION	5.5	5.6	6.8
FAMILY HOUSING	2.9	2.9	3.4
OTHER	4.7	1.6	0.5
TOTAL	286.8	289.4	311.6
PL 99-177	-	-11.0	-
NET B A	**286.8**	**278.4**	**311.6**

CHART 9

FY 1987 DOD BUDGET
BUDGET AUTHORITY BY TITLE
(CURRENT $ BILLIONS)

	FY 1985	FY 1986	FY 1986 G-R-H	FY 1987
MILITARY PERSONNEL	67.8	67.9	-0.2	76.8
O&M	77.8	78.7	-3.8	86.4
PROCUREMENT	96.8	97.3	-4.7	95.8
RDT&E	31.3	35.5	-1.7	42.0
MILITARY CONSTRUCTION	5.5	5.6	-0.3	6.8
FAMILY HOUSING	2.9	2.9	-0.1	3.4
OTHER	4.7	1.6	-0.1	0.5
TOTAL	286.8	289.4	-11.0	311.6

CHART 10

FY 1987 DOD BUDGET
BUDGET AUTHORITY BY MILITARY FUNCTION
(CURRENT $ BILLIONS)

	FY 1985	FY 1986	FY 1987
ARMY	74.3	74.9	81.5
NAVY/ MARINE CORPS	99.0	98.5	104.5
AIR FORCE	99.4	98.3	105.2
DEFENSE AGENCIES	13.1	15.9	19.5
DEFENSE WIDE	1.0	1.9	0.9
TOTAL	286.8	289.4	311.6
PL 99-177	-	-11.0	-
NET B A	**286.8**	**278.4**	**311.6**

CHART 11

FY 1987 DOD BUDGET
BUDGET AUTHORITY BY MILITARY FUNCTION
(CURRENT $ BILLIONS)

	FY 1985	FY 1986	FY 1986 G-R-H	FY 1987
ARMY	74.3	74.9	-2.5	81.5
NAVY/ MARINE CORPS	99.0	98.5	-3.7	104.5
AIR FORCE	99.4	98.3	-3.9	105.2
DEFENSE AGENCIES	13.1	15.9	-0.8	19.5
DEFENSE WIDE	1.0	1.9	*	0.9
TOTAL	286.8	289.4	-11.0	311.6

* Less than 0.1

CHART 12

FY 1987 DEPARTMENT OF DEFENSE BUDGET

MANPOWER
(IN THOUSANDS)

	FY 1985	FY 1986	FY1987	Change FY 86-87
MILITARY ACTIVE DUTY				
ARMY	781	781	781	-
NAVY	571	581	593	+ 12
MARINE CORPS	198	199	200	+ 1
AIR FORCE	602	606	607	+ 1
TOTAL MILITARY 1	2,151	2,167	2,181	+ 14
RESERVE MANPOWER				
SELECTED RESERVES	1,088	1,134	1,186	+ 52
CIVILIAN MANPOWER				
TOTAL CIVILIAN 2	1,129	1,110	1,114	+ 4

Note: 1. Includes Military assigned to Defense Agencies and Cadets.

2. Civilian End Strength includes Classified, Wage Board, Foreign Indirect, Civilian Technicians, and Permanent Part-time.

CHART 13

PERCENT OF RECRUITS WITH HIGH SCHOOL DIPLOMAS

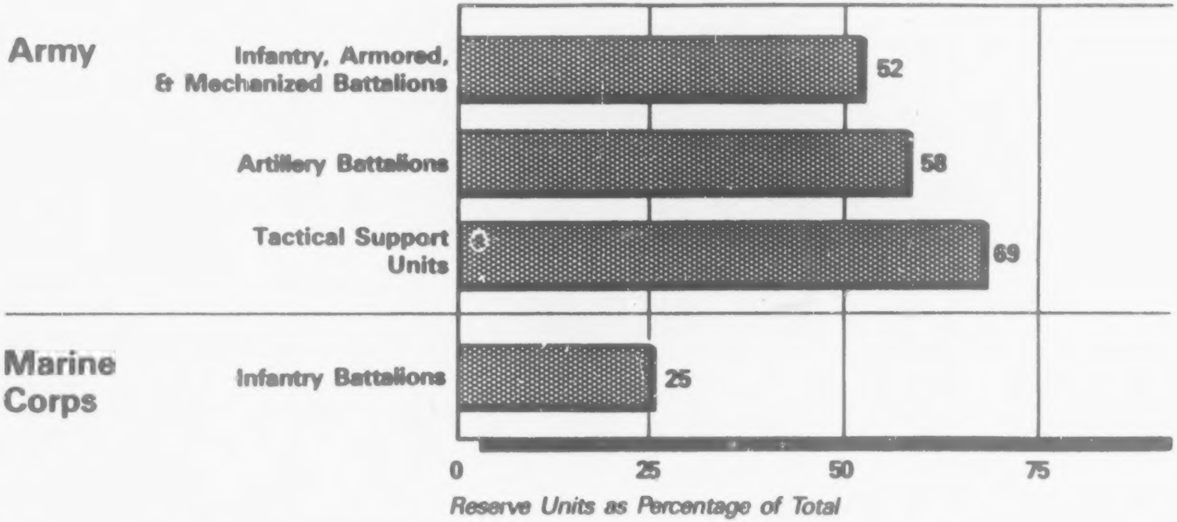
Service	1980	1981	1982	1983	1984	1985
Army	54	80	86	88	91	91
Navy	75	76	79	91	93	89
Marine Corps	78	80	85	92	95	97
Air Force	83	88	94	98	99	99
Total	68	81	86	91	93	93

PERCENT OF FIRST TERM REENLISTMENTS

Army	50.6	55.0	58.6	45.3	43.8	43.1
Navy	36.7	41.7	50.3	55.7	58.0	54.5
Marine Corps	23.2	26.6	34.0	33.3	39.5	35.4
Air Force	35.8	42.9	56.9	65.8	61.9	53.9
Total	39.1	43.0	52.9	51.6	51.2	47.8

CHART 14

PROJECTED CONTRIBUTION of RESERVE COMPONENTS
(END OF FY 1987)



ANNUAL CHANGE IN GUARD AND RESERVE FUNDING
(Less Congressional Adds - $ in Millions)

FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987
+ 420	+ 1,534	+ 2,177	+ 3,594	+ 1,860	+ 740

CHART 15

Major Equipment Procured for Guard/Reserve

	FY 1985	FY 1986	FY 1987
Army			
AH-64 Attack Helicopters	18	18	-
UH-60 Blackhawk Helicopters	2	15	32
Bradley Fighting Vehicles	174	32	-
M-1 Abrams Tanks	180	60	120
High Mobility Multipurpose Wheeled Vehicles (HMMWV)	1,572	5,872	2,476
Navy			
UH-60 Blackhawk Helicopters	2	4	-
KC-130T Tanker Aircraft	2	2	-
MK-15 Close In Weapon System (PHALANX)	4	6	1
M-198 Towed Howitzers	-	50	36
High Mobility Multipurpose Wheeled Vehicles (HMMWV)	643	1,719	-
Air Force			
C-130H Aircraft	16	16	-
F-16 Aircraft	30	-	-
Fuel Tank Trucks	50	45	57
Flightline Tow Tractors	115	41	77
Fire/Crash Trucks	84	69	102

CHART 16

ARMY MODERNIZATION

	On Hand		FY 1986 & Prior Auth/Approp & soon to be delivered	FY 1987
	FY 1980	FY 1985		
Close Combat				
M-1 Tanks	34	3,021	1,956	840
Bradley Fighting Vehicles	-	1,936	1,735	870
Helicopters				
AH-64 Apache	-	45	408	144
UH-60 Blackhawk	-	684	93	78
Air Defense Missiles				
Patriot	-	612	1,563	700
Stinger	-	6,554	8,005	4,180
Artillery				
M L R S	-	204	144	44

CHART 17

NAVY/MARINE CORPS MODERNIZATION

	On Hand		FY 1986 & Prior Auth/Approp & soon to be delivered	
	FY 1980	FY 1985		FY 1987
Tactical Aircraft				
F-14A	322	430	54	15
F/A-18	-	234	252	120
AV-8B	-	32	105	42
P-3C	176	229	21	9
Ships				
SSN-688 Submarine	10	28	24	4
AEGIS Ships	-	3	17	5
Frigates	71	112	5	-
Battleship Reactivation	-	2	2	-
Trident Submarine	-	6	7	1
Strategic Missiles				
TRIDENT I	144	518	52	-
TRIDENT II	-	-	-	21
Tactical Missiles				
Sidewinder	4,510	5,899	1,823	627
Sparrow	2,236	2,753	2,932	1,716

CHART 18

AIR FORCE MODERNIZATION

	On Hand		FY 1986 & Prior Auth/Approp & soon to be delivered	FY 1987
	FY 1980	FY 1985		
Tactical Fighters				
F-15	507	728	105	48
F-16	157	838	398	216
Strategic Aircraft				
B-1B	-	2	100	-
Mobility Aircraft				
KC-10	-	35	57	8
C-5B	-	-	29	21
Strategic Missiles				
PEACEKEEPER	-	-	54	21
ALCM-B	12	1,472	267	-
Nuclear/Tactical Missiles				
GLCM	-	196	288	76
Sparrow	8,192	10,302	1,965	379
Sidewinder	11,617	16,753	3,581	1,710

CHART 19

SPECIAL OPERATIONS EXPANSION

	FY 1981	FY 1987
Total Funding ($ millions)	$441	$1,693
MC-130 Aircraft	0	5
Special Forces Groups (includes four Reserve Components)	7	8
Ranger Battalions	2	3
Psychological Operations Battalions	3	4
SEAL Teams	2	5 1/
SEAL Delivery Vehicle (SDV) Teams	0	2 1/
Seafox (Special Warfare Craft, Light)	8	36

1/ Includes two Underwater Demolitions Teams redesignated in 1983.

CHART 20

MAJOR FY1987 RDT&E PROGRAMS
($ in Millions)

	FY 1986	FY 1987
Strategic Defense Initiative	2,746	4,785
LHX Helicopter & Engine	114	155
DIVAD Alternatives	31	104
V-22 (JVX) Tilt Rotor Aircraft	555	387
SSN-21 Attack Submarine/SUBACS	576	670
Advanced Tactical Fighter	165	294
Small ICBM (Incl. Basing)	746	1,396
PEACEKEEPER (Incl. Basing)	696	721

CHART 21

IMPROVEMENTS IN MUNITIONS SUSTAINABILITY
(PERCENT INCREASE OVER FY 1981 POSTURE)

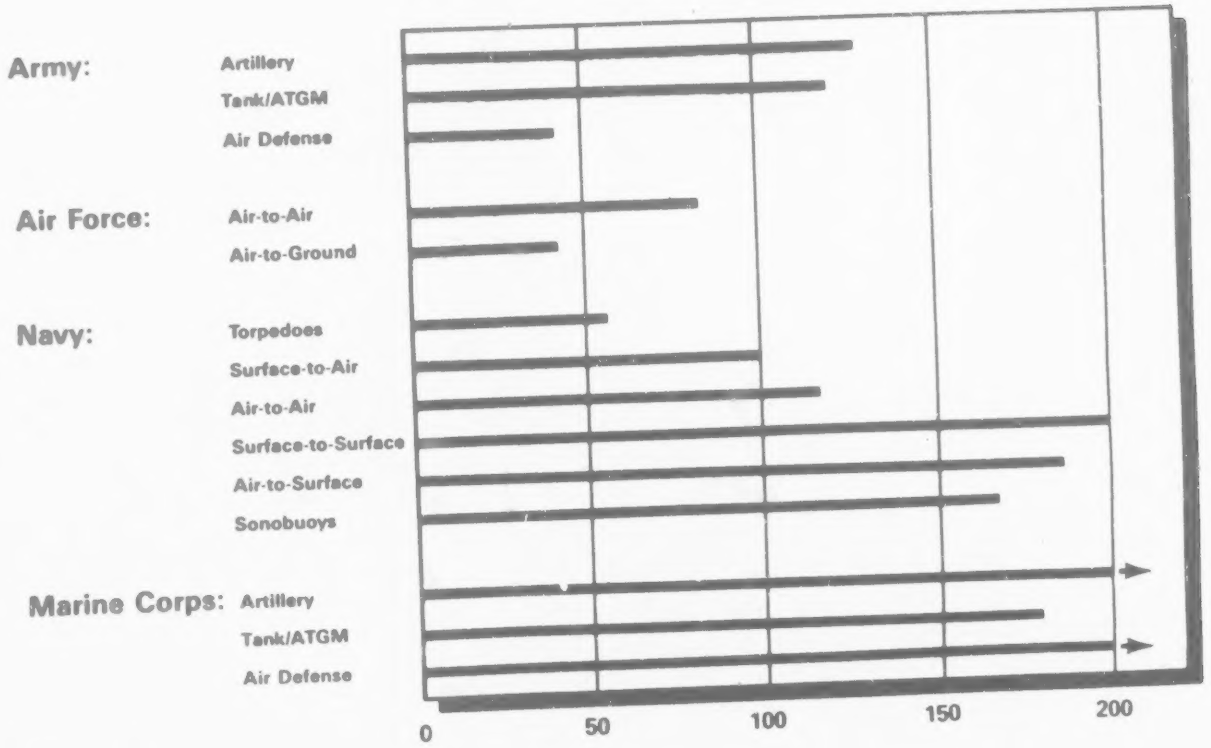
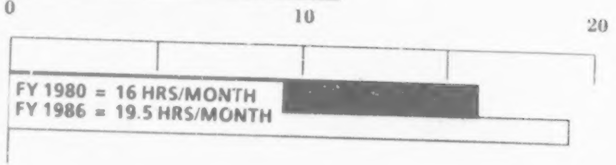


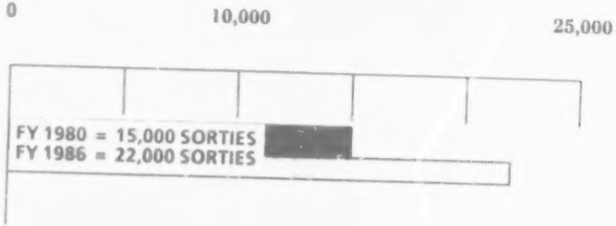
CHART 22

TRAINING IMPROVEMENTS

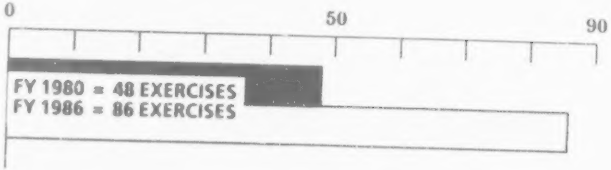
Air Force Tactical Aircrews:
19.5 flying hours/month



Air Force Tactical Aircrews:
22,000 Red Flag exercise sorties



Increased JCS Exercises:
86 Exercises



Army Battalions:
28 battalions/year rotating through National Training Center

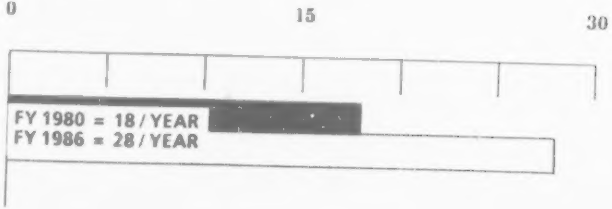


CHART 23

ACQUISITION IMPROVEMENTS

- **Cost Growth for Major Weapon Systems:**
  - end of CY 1980 14%
  - end of CY 1983/CY 1984 1%
- **Multiyear Procurements:**
  - FY 1982 - FY 1986:
    - 40 multiyear contracts approved/$6.2 billion in projected savings
  - FY 1987 budget :
    - 7 multiyear programs requested/$2.1 billion in anticipated savings
- **Increased Use of Competitive Contracts:**
  - 72% of all FY 1985 contracts competitively awarded (40% in FY 1981)
- **Spare Parts Acquisition Initiatives:** Savings of $2.5 billion
- **Economic Production Rates:** Savings of $2.7 billion

CHART 24

MANAGEMENT IMPROVEMENTS

FINANCIAL MANAGEMENT:

- **Saved $225 million through improved cash management and disbursement procedures.**
- **Reduced the DoD's interest payment by $600,000.**

INTERNAL MANAGEMENT CONTROL:

- **Documented a 78% improvement in internal management controls.**

ADP:

- **Reduced uneconomical leases of ADP equipment by $905 million through cost-efficient purchasing.**

CHART 25

DOD EFFORTS TO CURB WASTE, FRAUD and ABUSE - FY 1985

CONTRACT AUDITS:

- **ESTIMATED SAVINGS** **$8.1 billion**

INTERNAL AUDIT of DOD ACTIVITIES:

- **ESTIMATED SAVINGS** **$2.7 billion**

INVESTIGATIVE ACTIVITIES:

- **RECOVERIES, RESTITUTIONS, and FINES/PENALTIES** **$125.9 million**

CHART 26

FY 1987 DEPARTMENT OF DEFENSE BUDGET
LONG RANGE FORECAST
($ Billions)

	FY1987	FY1988	FY1989	FY1990	FY1991
BUDGET AUTHORITY					
CURRENT DOLLARS	311.6	332.4	353.5	374.7	395.5
OUTLAYS					
CURRENT DOLLARS	278.0	293.2	314.7	336.0	356.6
PL 99-177	-3.8	-2.5	-1.4	-0.5	-
NET OUTLAYS	274.3	290.7	313.3	335.5	356.6

Chairman DOMENICI. Admiral, would you like to make some remarks now?

STATEMENT OF ADM. WILLIAM J. CROWE, JR., USN, CHAIRMAN, JOINT CHIEFS OF STAFF

Admiral CROWE. Thank you, Mr. Chairman. I have submitted a statement for the record. However, in the interest of time, and also to avoid redundancy, I would like to just summarize those remarks.

Chairman DOMENICI. It will be made a part of the record.[1]

Admiral CROWE. I am convinced that the current posture of the armed forces is sound, Mr. Chairman. From personal observations over the last 5 years in major commands in both NATO and in the Pacific, I can testify that your investment in national defense over the last few years has paid huge dividends, and I do that with great confidence, Mr. Chairman.

Likewise, I believe there is a great deal yet to be done to ensure the republic's future security, and I will stress that throughout my statement.

First, I believe it is imperative to understand that our military posture provides us a great deal more than simply a shield against direct attack.

That same power underwrites our ability to use the sea lanes, to communicate with our friends overseas, to use the sea lanes for trade, to approach arms control negotiations with confidence, and to cement alliances which in turn enhance our own security.

In fact, our strength has been an indispensable pillar, not only of our own freedom, but that of our friends and allies as well.

Before returning to Washington I witnessed this firsthand as I served in command billets that brought me in contact with most of our major allies, and a good share of the Third World.

In NATO, I observed that our military contribution to that coalition literally anchors its unity and political structure.

In the Pacific, a succession of Asian leaders emphasized to me the importance of a powerful America with forces forward-deployed in the Far East.

Last month I visited both Central America and the Middle East, and I found officials there, in both areas, wanting a strong United States as a backdrop for their efforts to build free and functioning societies.

In essence, I would argue with fervor, our military capability provides us a host of benefits every day, a return on our investment, so to speak, in terms of national security and foreign policy.

At the same time, it is important to recognize that our strategy is determined not only by our own interests, but the actions of others as well, particularly our opponents. Over the last 30 years, every one of my predecessors has expressed concern about the Soviet worldwide threat, and the evolving military balance.

SOVIET BUILDUP UNPRECEDENTED IN WORLD HISTORY

Today, the size of Soviet forces and the scale and momentum of the Kremlin's modernization efforts are still of significant concern.

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[1] See p. 199.

And I will not dwell on the statistics and the adverse ratios we face, because Russian accomplishments are well-documented and this committee is aware of them. Secretary Weinberger has spoken to that.

In sum, this buildup is unprecedented in world history, and on sheer momentum alone will carry into the 1990's, if not longer.

In this regard, it is important to note a few realities. Soviet military doctrine consistently stresses the offense and a war-winning philosophy.

The Kremlin is today capable of waging war on two fronts: East and West. The U.S.S.R. now has, literally, a global military reach.

Soviet arms customers are emerging as the military powerhouses and the troublemakers of Southeast Asia, the Middle East, Africa, the Caribbean, and Latin America.

And perhaps most disturbing, the qualitative edge that the West has long enjoyed in military hardware is being eroded. All things considered, I am persuaded that the United States will be in a far better position to influence the Gorbachev regime if we continue discussions and negotiations from a position of increasing, rather than sagging, military strength.

But whatever you decide, let it be based on a full and unemotional appreciation of the peril we face. These threats cannot be assumed away, nor is it necessary to overstate them. They are impressive and ominous in their own right.

Let me now move to the state of our Armed Forces. Last year, General Vessey testified before this committee, and the Secretary referred to this, and I quote his statement: "By every common sense measure, our forces are more ready than at any time in the recent past."

That statement remains valid today. First, manpower, which is the heart of our force structure. I certainly would not want to see reversed the remarkable improvements in our manpower situation over the last few years.

PERSONNEL READINESS AT ITS HIGHEST LEVEL

Overall personnel readiness is at its highest level of any peacetime period in our history, and particularly in the 40 years that I have served.

About 50 percent of the force are careerists, and, as a result, we have a solid cadre of midgrade officer and enlisted personnel who give us a foundation of leadership that we cannot afford to be without. I might say as an aside, Mr. Chairman, that the greatest reward of a career in the military, in the professional military, is the opportunity to associate day in and day out with young American men and women.

This generation is great. I see it demonstrated, and I personally have no concerns about the future as a result of my witnessing their performance in the military.

I am also pleased to report that fiscal year 1985 was another successful year, as measured by the quality of our recruits, and overall retention rates.

However, we do see some potential warning signs in enlisted retention, and in our ability to keep nuclear-trained officers and experienced pilots.

I would suggest that none of this is cause for great alarm immediately, but it does serve to remind us that personnel readiness is a very fragile thing, particularly given the fact that we are facing a shrinking manpower pool of our youngsters. Consequently, a healthy personnel structure is always the first priority of the Joint Chiefs of Staff.

MAINTAIN CREDIBLE NUCLEAR DETERRENT

Now, turning to force modernization. The United States has no choice but to maintain a credible nuclear deterrent for itself and for those nonnuclear allies who depend upon it. Unfortunately, United States strategic modernization lagged far behind Soviet efforts during the 1970's. As a result, we have been forced to refurbish all three legs of the triad at the same time, notably with the Peacekeeper missile, the B-1 bomber, and the Trident submarine.

Current plans call for placing 50 Peacekeepers into modified Minuteman silos. In addition, we urgently need to continue research into more survivable modes for basing the second 50 missiles, and development of a smaller ICBM/mobile launcher, and the advanced technology bomber.

In order to guard against tactical and technical surprise, it is essential to carry out the President's strategic modernization program, which, if we do, will close the gap for many years to come.

I have just returned from Europe, and was able to witness firsthand some of the new conventional equipment which has come into the inventory as a result of investments made over the last 6 years.

Incidentally, I drove an M-1 tank, my first time to drive a tank. At the same time, I was able to hear the people who drive them every day and fight in them, talk about how wonderful they are. I heard similar comments about all of the new equipment which is coming into both the ground forces and the air forces that we have based in NATO. I witnessed a similar phenomenon during my 2 years in the Pacific. We received a stream of modern weapon systems. All of this is most impressive, and is benefitting active, reserve, and National Guard forces alike.

It is not just quantity we are adding, but quality as well, and this is reflected in every aspect of the modern forces.

STILL MUCH TO BE DONE

It is also important, however, to stress that there is still much to do. To cite some end 1985 figures from the Active Forces: Only one-third of our tank battalions have the new M-1; only one-fourth of our mechanized battalions have the Bradley fighting vehicle, only one-fifth of the Air Defense SAM missile batteries are equipped with the new Patriot.

Two-thirds of the Air Forces tactical fighter squadrons have F-15's, F-16's, and A-10's. One-third of the Navy's submarine force is operating the new 688 class, and slightly over one-third of the Navy's battle groups have the new AEGIS-equipped ships.

More progress will be seen over the next 2 years, as equipment currently in the pipeline reaches our combat forces. But for our purposes today, it should be clearly understood that we are still midstream in the modernization effort. There is still a great deal to be done. To falter now would stretch out the entire process, leave many of our units behind the power curve in quality, frankly prove more expensive in the end, and give the Soviets another opportunity to commence widening the gap, a gap that we went through in the 1970's, and the post-Vietnam war period, a gap that I just would hate to see develop again.

The fiscal year 1987 budget recognizes this reality and continues the momentum. New acquisitions have been complemented by a rigorous training program designed to capitalize on their enhanced capabilities.

Our exercises are bringing together all the services and increasingly include National Guard and Reserve units.

LOGISTIC SIDE OF WAR FIGHTING BEING STRESSED

Likewise, we are stressing more and more the logistic side of war fighting. The Reforger exercise in Western Europe, for example, Team Spirit in Korea, and Centcom's, Bright Star in the Middle East, are annually enhancing our ability to project power to those areas where we have strong interests.

These three instances are just the tip of an exercise iceberg which is steadily becoming more joint, realistic, and inovative. Our training today is stimulating and exciting, and when you visit our people in the field, they will tell you so.

Other improvements can be seen in the sustainability or combat staying power of our forces. Over the last 6 years we have seen substantial growth in U.S. expenditures for sustainability. The funding for ammunition and spare parts has grown by over 25 percent, and ammunition inventories of all the services have improved substantially.

In Europe, for instance—and I saw this the other day—ground ammunition storage is up 18 percent, and that is probably the biggest munitions problem we have in the military—our European inventories.

Those same figures have almost doubled in the Pacific. Our people are developing a new confidence. They knew all along that they could fight well, they had good equipment, and that they were skilled, but they now are developing a new confidence that they can keep the field in a protracted conflict.

EMPHASIS PUT ON SUSTAINABILITY

That is new in my experience in the military. The fiscal year 1987 budget still puts considerable emphasis on sustainability and rightfully so, because we are not out of the woods yet in a number of categories.

We simply must stay the course if we want a genuinely sustainable force, as well as a sophisticated, and a well-trained one. Otherwise, we will be spending a great deal for modern equipment with one hand, and then reducing its effectiveness with the other.

Mr. Chairman, my summary is simple. We are on the road to recovery as a nation, in large part because we are on the road to recovery of our umbrella of security, our Armed Forces. Our increasing military power is pushing back many of the challenges that we face.

All over the world, we are regaining our self-respect and confidence, and this is reflected in our Armed Forces. There is a new excitement and confidence which is taking root as we have reversed the trends of the 1970's.

From my perspective, it is imperative that we make sure that those roots are permanent. There are other pressures on our Nation, but in my view, none so large, or as dangerous as those I have mentioned.

Domestic shortcomings and economic deficits are onerous challenges. I certainly do not envy you as you grapple with them.

I am not a politician, a sociologist or an economist, and I would not presume to advise you in fixing those problems. But as a longtime professional in national defense, I can tell you that we are at a critical juncture. If we take the wrong path, it will erode much of the progress which we have made, some of that very painful progress, and permit the Soviets, once again, to start widening the gap between us.

From a military perspective I would suggest this would be a serious mistake. It is imperative to convince the Kremlin we are a credible adversary, if we expect them to be deterred, or to talk, or to negotiate.

Finally, as the leader of the free world, we must continue to be the bulwark and the unifier of our allies, so that we can all profit from our mutual strength.

The fiscal year 1987 President's budget provides a reasonable means to overcome the downturn in 1986, and to take another step toward these key goals.

I would urge that you stay the course by supporting that budget. That completes my statement.

Chairman DOMENICI. Thank you very much, Admiral.

[The prepared statement of Admiral Crowe follows:]

STATEMENT OF
ADMIRAL WILLIAM J. CROWE, JR., USN
CHAIRMAN OF THE JOINT CHIEFS OF STAFF
ON
FY 1987 DOD BUDGET
BEFORE THE
SENATE BUDGET COMMITTEE

6 FEBRUARY 1986

INTRODUCTION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE,

I WELCOME THE OPPORTUNITY TO APPEAR BEFORE THIS COMMITTEE TODAY AND PROVIDE MY ASSESSMENT OF THE NATION'S DEFENSE ESTABLISHMENT. WHILE I AM CONVINCED THAT THE CURRENT POSTURE OF THE ARMED FORCES IS SOUND, I LIKEWISE BELIEVE THERE IS A GREAT DEAL YET TO BE DONE TO INSURE THE NATION'S FUTURE SECURITY -- PARTICULARLY IN THE FACE OF A STEADILY INCREASING SOVIET THREAT AND MOSCOW'S BROADENING USE OF SURROGATES. I AM, OF COURSE, AWARE THAT THERE IS SOME PRESSURE TO CUT BACK DEFENSE APPROPRIATIONS IN AN EFFORT TO ASSIST IN REDUCING THE CURRENT NATIONAL DEFICIT. THEREFORE, I BELIEVE IT IMPORTANT, IN MY FIRST OPPORTUNITY AS CHAIRMAN TO TESTIFY ON THE BUDGET, THAT I COMMENT NOT ONLY ON THE STATUS OF OUR ARMED FORCES, BUT AS WELL ON THE ROLE MILITARY STRENGTH PLAYS IN U.S. POLICY-MAKING AND IN THE AMERICAN RELATIONSHIP WITH THE INTERNATIONAL COMMUNITY. I WOULD STRONGLY ARGUE THAT DELIBERATIONS ON THE MILITARY BUDGET SHOULD COMMENCE WITH A CLEAR UNDERSTANDING OF WHAT OUR DEFENSE ESTABLISHMENT DOES FOR US.

THE ROLE OF U.S. MILITARY STRENGTH

THE SECRETARY OF DEFENSE HAS PROVIDED THE CONGRESS WITH A COMPREHENSIVE STATEMENT OF U.S. DEFENSE POLICY. THAT STATEMENT NOTES, AMONG OTHER THINGS, THAT THE FUNDAMENTAL GOALS OF OUR

NATIONAL SECURITY POLICY HAVE REMAINED ESSENTIALLY UNCHANGED SINCE THE 1940'S:

-- TO PRESERVE THE INDEPENDENCE, FREEDOM OF ACTION AND TERRITORIAL INTEGRITY OF THE UNITED STATES;

-- TO PRESERVE U.S. AND ALLIED VITAL INTERESTS ABROAD; AND

-- TO SHAPE AN INTERNATIONAL ORDER IN WHICH OUR FREEDOMS AND DEMOCRATIC INSTITUTIONS CAN SURVIVE AND PROSPER.

THESE ARE NOT JUST EMPTY WORDS -- THEY GENUINELY DESCRIBE WHAT OUR STRENGTH CAN AND DOES DO FOR US. IT HAS PROVIDED US A GREAT DEAL MORE THAN SIMPLY A SHIELD AGAINST DIRECT ATTACK. THAT SAME POWER UNDERWRITES OUR DEALINGS WITH THE INTERNATIONAL COMMUNITY -- FOR EXAMPLE, TO USE THE SEA LANES, TO COMMUNICATE WITH FRIENDS OVERSEAS, TO APPROACH ARMS CONTROL NEGOTIATIONS WITH CONFIDENCE, AND TO CEMENT ALLIANCES WHICH, IN TURN, ENHANCE OUR OWN SECURITY. IN FACT, OUR STRENGTH HAS BEEN AN INDISPENSABLE PILLAR NOT ONLY OF OUR OWN FREEDOM BUT ALSO THE FREEDOM OF OUR FRIENDS AND ALLIES AROUND THE WORLD.

FOR FIVE YEARS BEFORE RETURNING TO WASHINGTON, I SERVED IN COMMAND BILLETS THAT BROUGHT ME IN TOUCH WITH MOST OF OUR MAJOR ALLIES AND A GOOD SHARE OF THE THIRD WORLD. IN NATO, I OBSERVED FIRSTHAND THAT OUR MILITARY CONTRIBUTION TO THAT COALITION ANCHORS ITS UNITY AND POLITICAL STRUCTURE. WHEN I SERVED AS USCINCPAC, A SUCCESSION OF ASIAN LEADERS EMPHASIZED TO ME THE IMPORTANCE OF A

STRONG AMERICA WITH FORCES FORWARD-DEPLOYED IN THE WESTERN PACIFIC. IN THEIR VIEW, OUR STRENGTH HAS DETERRED SOVIET INTERFERENCE AND INTIMIDATION. BEHIND THAT BULWARK THEY HAVE BEEN ABLE TO SEEK ECONOMIC PROSPERITY AND POLITICAL MATURITY IN THEIR OWN FASHION AND AT THEIR OWN PACE. I WAS CONTINUALLY WARNED THAT A DECIDED SOVIET MILITARY SUPERIORITY IN THE PACIFIC WOULD BE DISASTROUS. IN THE LAST MONTH I HAVE VISITED BOTH CENTRAL AMERICA AND THE MIDDLE EAST. CLEARLY, THE LEADERS IN BOTH AREAS WANT A STRONG AMERICA AS A BACKDROP FOR THEIR EFFORTS TO BUILD FREE AND FUNCTIONING SOCIETIES. TO ALLOW OUR STRENGTH TO DETERIORATE WOULD SERIOUSLY UNDERMINE THEIR EFFORTS AS WELL AS SACRIFICE OUR OWN GOALS.

IN ESSENCE, OUR MILITARY CAPABILITY PROVIDES US A HOST OF BENEFITS IN TERMS OF BOTH NATIONAL SECURITY AND FOREIGN POLICY. EVERY DAY WE ARE REALIZING A RETURN ON OUR INVESTMENT AS THE ARMED FORCES PROVIDE AN UMBRELLA UNDER WHICH ALL OUR OTHER CARDS ARE PLAYED.

THESE CONSIDERATIONS HAVE, OVER THE YEARS, SHAPED OUR GENERAL MILITARY STRATEGY. ITS KEY COMPONENTS ARE:

-- COLLECTIVE SECURITY COUPLED WITH A VIGOROUS OVERSEAS DEFENSE OF THE UNITED STATES.

-- A STRONG AND CREDIBLE STRATEGIC DETERRENT TO EITHER NUCLEAR OR CONVENTIONAL MILITARY ATTACK ON THE U.S. AND/OR ITS ALLIES.

-- CAPABLE FORWARD-DEPLOYED CONVENTIONAL FORCES TO ASSIST

ALLIES AND TO DEAL QUICKLY WITH EMERGING CRISES.

-- A CENTRAL RESERVE TO AUGMENT FORWARD-DEPLOYED UNITS OR DEAL WITH THE UNFORESEEN OVER A WIDE SPECTRUM OF VIOLENCE (TO INCLUDE LOW-INTENSITY CONFLICT AND COUNTERTERRORISM) AND IN A VARIETY OF CLIMES.

-- THE SEA AND AIRLIFT CAPABILITY TO PROJECT AND SUPPORT U.S. FORCES ON A GLOBAL BASIS.

-- THE ABILITY TO ENSURE AMERICA'S FREE AND UNINTERRUPTED USE OF THE SEAS FOR TRADE AND SECURITY PURPOSES.

-- A VIGOROUS SECURITY ASSISTANCE PROGRAM TO AID ALLIES AND FRIENDS IN IMPROVING THEIR ABILITY TO DEFEND THEMSELVES.

-- A WILLINGNESS TO ENGAGE IN MEANINGFUL ARMS LIMITATION NEGOTIATIONS.

THESE PRINCIPLES, OF COURSE, COMBINE TO MAKE UP OUR MILITARY POLICY. GRANTED, IT IS A DEMANDING STRATEGY, BUT ONE THAT BEFITS OUR GOALS AND OUR POSITION AS A LEADER OF THE FREE WORLD. EVEN THOUGH THIS STRATEGY DOES NOT CALL FOR THE U.S. TO MATCH ITS ADVERSARIES WEAPON FOR WEAPON, I OFTEN HEAR THE ARGUMENT THAT WE SHOULD CUT BACK OUR COMMITMENTS TO BETTER FIT OUR RESOURCES. BUT THE PROPONENTS OF SUCH A PHILOSOPHY DON'T SEEM TO BE ABLE TO REACH AGREEMENT ON WHAT COMMITMENTS TO CUT BACK, WHAT REGIONS TO NEGLECT OR WHAT ALLIES TO CUT ADRIFT. WITHOUT SUCH A CONSENSUS, THE ARGUMENT HAS LITTLE FORCE -- PARTICULARLY IN TODAY'S INTERDEPENDENT

AND UNCERTAIN WORLD.

THE THREAT

BY DEFINITION, OUR STRATEGY IS DETERMINED NOT ONLY BY OUR OWN INTERESTS BUT ALSO BY THE ACTIONS OF OUR OPPONENTS. AS SECRETARY WEINBERGER EMPHASIZES IN HIS STATEMENT, "IN THIS RESPECT THE SOVIET UNION REMAINS THE DOMINANT CONSIDERATION." MOSCOW STILL HARBORS DREAMS OF UNLIMITED EXPANSION AND OF THE ULTIMATE DEFEAT OF THE FREE WORLD. YET COMMUNISM'S IDEOLOGICAL APPEAL HAS STEADILY LOST GROUND AND THE KREMLIN HAS BEEN PLAGUED WITH A HOST OF INTRACTABLE ECONOMIC AND POLITICAL PROBLEMS. AS A RESULT, SOVIET LEADERS ARE TURNING MORE AND MORE TO RAW POWER TO ACHIEVE THEIR OBJECTIVES EITHER DIRECTLY OR INDIRECTLY -- WITNESS AFGHANISTAN, CAMBODIA, ANGOLA, NICARAGUA, ETC. THE THRUST OF THEIR MILITARY BUILDUP IS AMBITIOUS, HOSTILE TO FREE GOVERNMENTS, AND PERSISTENT.

OVER THE LAST 30 YEARS, EVERY ONE OF MY PREDECESSORS HAS EXPRESSED CONCERN ABOUT THE SOVIET WORLDWIDE THREAT AND THE EVOLVING MILITARY BALANCE. TODAY, THE SHEER SIZE OF CURRENT SOVIET FORCES, AND THE SCALE AND MOMENTUM OF THE KREMLIN'S MODERNIZATION EFFORTS ARE OF SIGNIFICANT CONCERN. TREMENDOUS ADVANCES HAVE BEEN MADE IN HARDWARE OVER THE LAST TWO DECADES, UPSETTING MANY OF THE ADVANTAGES WE HELD IN THE IMMEDIATE POST-WAR PERIOD.

FOR EXAMPLE, THE STRATEGIC NUCLEAR BALANCE HAS SHIFTED DRAMATICALLY. THE SOVIETS NOW ENJOY SUPERIORITY IN ICBMS, MEDIUM-

RANGE NUCLEAR FORCES AND IN MOBILE BALLISTIC MISSILES. THEY ARE A BURGEONING NUCLEAR POWER INTENT ON ACHIEVING DOMINANCE OVER THE U.S. STRATEGIC DETERRENT. AS TO CONVENTIONAL ARMS, THEY LEAD THE WORLD. THE SOVIET INVENTORY INCLUDES ABOUT A 4 TO 1 ADVANTAGE OVER THE UNITED STATES IN TANKS, 2 TO 1 IN AIRCRAFT, AND 5 TO 1 IN ARTILLERY. THESE GAPS WILL LIKELY CONTINUE TO GROW SINCE THE SOVIETS HAVE HISTORICALLY PRODUCED MORE WEAPONS THAN THE COMBINED EFFORTS OF THE UNITED STATES AND NATO. THE PERSONNEL PICTURE IS NO DIFFERENT. ACTIVE SOVIET MILITARY FORCES OUTNUMBER U.S. ACTIVE FORCES BY ABOUT 2 TO 1. SIMILARLY, THEIR PROGRESS IN SPACE COMMANDS DEEP RESPECT; E.G., SATELLITES, ABMS AND ASATS. PERHAPS MOST IMPRESSIVE IS THE RISE OF THE SOVIET NAVY IN THE LAST 30 YEARS FROM A SHORT-LEGGED REGIONAL FORCE TO A BLUE WATER FLEET WITH A GLOBAL REACH. I WON'T DWELL ON STATISTICS BECAUSE RUSSIAN ACCOMPLISHMENTS ARE WELL DOCUMENTED IN OUR POSTURE STATEMENT AND DEFENSE LITERATURE. IN SUM, THIS BUILDUP IS UNPRECEDENTED IN WORLD HISTORY AND ON SHEER MOMENTUM WILL CARRY WELL INTO THE 1990'S, IF NOT LONGER. IN THIS REGARD, IT IS IMPORTANT TO NOTE:

-- SOVIET MILITARY DOCTRINE CONSISTENTLY STRESSES THE OFFENSE AND A "WAR WINNING" PHILOSOPHY.

-- THEIR FORCES VASTLY EXCEED THOSE NECESSARY TO DEFEND THEIR OWN SHORES.

-- THEY ARE TODAY CAPABLE OF WAGING WAR ON TWO FRONTS, BOTH IN

THE EAST AND IN THE WEST.

-- GIVEN THEIR MODERN NAVY AND POLITICAL CONNECTIONS WITH SATELLITE COUNTRIES, THEY NOW HAVE A "GLOBAL MILITARY REACH."

-- THE SOVIETS POSSESS AN OVERWHELMING SUPERIORITY IN THE AREA OF OFFENSIVE CHEMICAL WEAPONS.

-- MOST DISTURBING, THE QUALITATIVE EDGE THE WEST HAS LONG ENJOYED IS BEING ERODED. THIS HAS BEEN ACHIEVED THROUGH LARGE R&D INVESTMENTS, EMPHASIS ON TECHNOLOGICAL EDUCATION (4 TIMES AS MANY ENGINEERS AS THE U.S. IN THE LAST 10 YEARS), PIRACY OF WESTERN TECHNOLOGY, AND A WILLINGNESS TO ACCEPT INEFFICIENCIES IN THE PROCESS.

SPECIAL MENTION MUST BE MADE OF THE INCREASING SOVIET TENDENCY TO ACT THROUGH SURROGATES. THE USSR IS THE WORLD'S LARGEST ARMS SALESMAN, DELIVERING SOME $95 BILLION IN WEAPONS OVER THE LAST DECADE. APPROXIMATELY $80 BILLION WORTH OF EQUIPMENT, SOME NEW AND SOME OUTDATED BY SOVIET STANDARDS, HAS BEEN FUNNELED INTO THE THIRD WORLD DURING THE SAME PERIOD. IN TURN, SOVIET CUSTOMERS ARE EMERGING AS THE MILITARY POWERHOUSES OF SOUTHEAST ASIA, THE MIDDLE EAST, AFRICA, CARIBBEAN, AND LATIN AMERICA. MOREOVER, MOSCOW CONTINUES TO BE SUCCESSFUL IN HAVING ITS CLIENTS ACT AGAINST WESTERN GOVERNMENTS AND PEOPLES. THE RESULT IS A BURGEONING TERRORIST THREAT, MORE SMALL BUT FIERCE REGIONAL CONFLICTS, AND AN INCREASING WILLINGNESS OF SMALL ANTI-AMERICAN REGIMES TO CHALLENGE

WASHINGTON. PERHAPS THIS TREND IS THE RESULT OF OUR SUCCESS IN PRESERVING A ROUGH BALANCE OF POWER WHICH DETERS DIRECT SOVIET ACTION AGAINST THE WEST, BUT THE FACT REMAINS IT PRESENTS A SERIOUS AND GROWING CHALLENGE TO THE U.S. MILITARY.

CONCURRENTLY, WE SEE NEW LEADERSHIP IN THE KREMLIN WHICH APPEARS TO BE REINVIGORATING THE PARTY APPARATUS. WE ALSO KNOW THAT WITH ALL OF ITS MILITARY MUSCLE, THE KREMLIN FACES SOME VERY THORNY POLITICAL, ECONOMIC AND SOCIAL PROBLEMS. HOW ALL OF THIS WILL AFFECT SOVIET BEHAVIOR OVER THE NEXT FEW YEARS REMAINS TO BE SEEN. I AM CONVINCED, HOWEVER, THAT THE U.S. WILL BE IN A FAR BETTER POSITION TO INFLUENCE THE GORBACHEV REGIME IF WE CONTINUE DISCUSSIONS AND NEGOTIATIONS FROM A POSITION OF INCREASING RATHER THAN SAGGING MILITARY STRENGTH.

WHATEVER YOU DECIDE, LET IT BE BASED ON A FULL AND UNEMOTIONAL APPRECIATION OF THE PERIL WE FACE. THESE THREATS CANNOT BE ASSUMED AWAY NOR IS IT NECESSARY TO OVERSTATE THEM. THEY ARE IMPRESSIVE AND OMINOUS IN THEIR OWN RIGHT.

CURRENT STATUS AND THE FY 1987 BUDGET

LET ME NOW MOVE TO THE STATE OF OUR ARMED FORCES. LAST YEAR, GENERAL VESSEY TESTIFIED BEFORE THIS COMMITTEE THAT "BY EVERY COMMON SENSE MEASURE, OUR FORCES ARE MORE READY THAN AT ANY TIME IN THE RECENT PAST." THAT STATEMENT REMAINS VALID TODAY AND IS MADE POSSIBLE BY THE SUPPORT OF OUR CITIZENRY AND THE CONGRESS. ON

BEHALF OF THE MEN AND WOMEN IN THE ARMED FORCES, I THANK YOU. EACH OF THE SERVICE CHIEFS WILL TESTIFY IN SOME DETAIL AS TO THE MAJOR CONCERNS AND THE REQUIREMENTS OF HIS SERVICE. I WILL SPEAK TO OUR OVERALL WARFIGHTING CAPABILITY FROM MY PERSPECTIVE AS CHAIRMAN. TO DO THIS, I HAVE SELECTED FIVE BROAD AREAS OF INTEREST -- MANPOWER, MODERNIZATION, TRAINING, SUSTAINABILITY, AND SPECIAL OPERATIONS FORCES. BEFORE PROCEEDING, HOWEVER, A FEW WORDS ARE IN ORDER CONCERNING THE FY 1986 FISCAL CLIMATE.

AS A RESULT OF A DECISION TO LEVEL DEFENSE SPENDING THIS YEAR AND SUBSEQUENT ACROSS-THE-BOARD CUTS, MANDATED BY PUBLIC LAW 99-177, WE ALREADY HAVE SEEN A NUMBER OF FUNDING DISLOCATIONS WHICH WILL IMPACT ON OUR MILITARY POSTURE. THIS INCLUDES A FIVE PERCENT REDUCTION IN OPERATIONS AND MAINTENANCE FUNDING WHICH IS FORCING SOME BELT TIGHTENING IN SUCH AREAS AS BASE MANAGEMENT, OPERATIONS TEMPO, AND ESSENTIAL MAINTENANCE. FURTHER, WE SEE SOME FREEZES IN CIVILIAN HIRING AS WELL AS REALIGNMENTS IN MILITARY PERSONNEL ROTATION AND TRAVEL ACCOUNTS. WHILE WE ARE STRIVING TO WORK AROUND THESE PROBLEMS, I CANNOT EMPHASIZE TOO STRONGLY THE ADVERSE IMPACT OF SUCH CUTS ON THE READINESS OF OUR FORCES AND THE STABILITY OF MILITARY LIFE. THEY THREATEN TO UNDO MUCH OF WHAT HAS BEEN ACCOMPLISHED IN THE LAST FEW YEARS AS WE HAVE FOUGHT BACK FROM THE NEGLECT FOLLOWING VIETNAM.

MANPOWER. IN PARTICULAR, I WOULD NOT WANT TO SEE REVERSED THE

REMARKABLE IMPROVEMENTS IN OUR MANPOWER SITUATION, WHICH IS THE HEART OF OUR FORCE STRUCTURE. OVERALL, PERSONNEL READINESS IS AT ITS HIGHEST LEVEL OF ANY PEACETIME PERIOD IN OUR HISTORY. ABOUT 50 PERCENT OF THE FORCE ARE CAREERISTS AND AS A RESULT, WE HAVE A SOLID CADRE OF MID-GRADE OFFICER AND ENLISTED PERSONNEL. THE NATION CAN BE EXTREMELY PROUD OF THE HIGH CALIBER OF ITS SERVICE MEN AND WOMEN.

FY 1985 WAS ANOTHER SUCCESSFUL YEAR FOR ALL THE SERVICES. THE QUALITY OF OUR RECRUITS EXCEEDED THAT OF FY 1984. NINETY-THREE PERCENT OF ALL OUR NON-PRIOR SERVICE ENLISTEES WERE HIGH SCHOOL DIPLOMA GRADUATES AND NINETY-THREE PERCENT AS WELL SCORED AVERAGE OR ABOVE ON THE ENLISTMENT TEST. HOWEVER, AS YOU ARE AWARE, THE YOUTH POPULATION FROM WHICH THE SERVICES CAN RECRUIT CONTINUES TO SHRINK, AND RECRUITING CAN BE EXPECTED TO BECOME A GROWING CHALLENGE IN THE FUTURE.

RETENTION CONTINUED AT VERY HIGH LEVELS FOR FY 1985 AS WELL, BUT NOT WITHOUT POTENTIAL WARNING SIGNS. OVERALL, ENLISTED RETENTION DECLINED FROM FY 1984 LEVELS FOR ALL SERVICES IN ALL CATEGORIES EXCEPT FOR FIRST TERMERS IN THE ARMY. THIS HAS AGGRAVATED SHORTAGES IN SOME OF OUR ENLISTED SKILLS. IN ADDITION, THE NAVY STILL IS HAVING DIFFICULTY RETAINING SUFFICIENT NUCLEAR OFFICERS AND, ALONG WITH THE AIR FORCE, CONTINUES TO LOSE EXPERIENCED PILOTS. IN AND OF ITSELF, NONE OF THIS IS CAUSE FOR

GREAT ALARM AT THIS TIME. BUT IT DOES SERVE TO REMIND US THAT PERSONNEL READINESS, RECOGNIZED AS THE CORNERSTONE OF OUR NATIONAL DEFENSE, IS VERY FRAGILE INDEED.

THE BOTTOM LINE IS THAT OUR MOST PRECIOUS ASSET IS QUALITY PERSONNEL; CONSEQUENTLY, AS WE APPROACH THE FY 1987 BUDGET A HEALTHY PERSONNEL STRUCTURE IS THE FIRST PRIORITY OF THE JOINT CHIEFS OF STAFF. IT IS IMPERATIVE THAT WE HAVE PROGRAMS WHICH WILL ATTRACT AND RETAIN ADEQUATE NUMBERS OF DEDICATED, INTELLIGENT AND DISCIPLINED SOLDIERS, SAILORS, AIRMEN AND MARINES. UNDER NO CIRCUMSTANCES CAN WE AFFORD TO RETURN TO THE UNSTABLE MANPOWER PICTURE OF THE 1970'S.

MODERNIZATION -- STRATEGIC NUCLEAR FORCES. TURNING TO FORCE MODERNIZATION, THE UNITED STATES HAS NO CHOICE BUT TO MAINTAIN A CREDIBLE NUCLEAR DETERRENT FOR ITSELF AND FOR THOSE NON-NUCLEAR ALLIES WHO DEPEND UPON IT. STATED IN DIFFERENT TERMS, WE SHOULD BE ABLE TO TELL THE SOVIET UNION: "YOU CANNOT COERCE US WITH YOUR NUCLEAR ARSENALS, BECAUSE IF YOU LAUNCH THOSE WEAPONS YOU WILL SUFFER AS MUCH IF NOT MORE DAMAGE THAN THE UNITED STATES."

UNFORTUNATELY, U.S. STRATEGIC FORCE MODERNIZATION LAGGED FAR BEHIND SOVIET EFFORTS DURING THE 1970'S. AS A RESULT, WE HAVE BEEN FORCED TO REFURBISH ALL THREE LEGS OF THE TRIAD AT THE SAME TIME -- NOTABLY WITH THE PEACEKEEPER MISSILE, THE B-1 BOMBER, AND THE TRIDENT SUBMARINE. CURRENT PLANS CALL FOR PLACING 50 PEACEKEEPERS

INTO MODIFIED MINUTEMAN SILOS. IN ADDITION, WE URGENTLY NEED TO CONTINUE RESEARCH INTO MORE SURVIVABLE MODES FOR BASING THE SECOND 50 MISSILES AND DEVELOPMENT OF A SMALLER ICBM/MOBILE LAUNCHER.

BY THE END OF THIS YEAR, THE FIRST 20 OF 100 B-1 BOMBERS WILL HAVE BEEN DELIVERED TO THE STRATEGIC AIR COMMAND. OVER THE NEXT SEVERAL YEARS, THIS PROGRAM WILL PARTIALLY AND TEMPORARILY MODERNIZE THE MANNED BOMBER ELEMENT OF OUR TRIAD. CONCURRENTLY, WE MUST MOVE AHEAD WITH THE ADVANCED TECHNOLOGY BOMBER (ATB), SO THAT IT CAN BE READY FOR DEPLOYMENT IN THE 1990'S. THEREAFTER, WE WILL HAVE A PRUDENT MIX OF B-1B AND ATB TYPES.

ADDITIONALLY, WE NOW HAVE 5 DEPLOYABLE TRIDENT I SUBMARINES, WITH 2 MORE ON SEA TRIALS. EACH CARRIES 24 IMPROVED C-4 MISSILES. IN VARIOUS PHASES, CONTRACTING AND CONSTRUCTION WORK CONTINUES ON AN ADDITIONAL 6 SUBMARINES FUNDED BY CONGRESS THROUGH FY 1986. THIS BUDGET WOULD FUND THE FOURTEENTH TRIDENT PLUS THE D-5 MISSILE. BECAUSE OF ITS HARD-TARGET KILL CAPABILITY, THE D-5 GOES A LONG WAY TOWARD INCREASING THE POTENCY AND CREDIBILITY OF OUR STRATEGIC NUCLEAR POSTURE.

IN ORDER TO GUARD AGAINST TACTICAL AND TECHNICAL SURPRISE, IT IS ESSENTIAL TO HAVE AN UPDATED AND HEALTHY TRIAD WHICH WILL SEE US INTO THE NEXT CENTURY. THE PRESIDENT'S MODERNIZATION PROGRAM WILL GIVE US THAT CAPABILITY IF IT IS FULLY CARRIED OUT. WE CANNOT AFFORD TO DO OTHERWISE.

LOOKING TO THE FUTURE, THE JOINT CHIEFS OF STAFF WHOLEHEARTEDLY SUPPORT THE PRESIDENT'S STRATEGIC DEFENSE INITIATIVE (SDI) WHICH WILL MUSTER THE NATION'S TECHNOLOGICAL TALENT TO DETERMINE WHETHER AN ALTERNATIVE TO SOLE RELIANCE ON MUTUAL ASSURED DESTRUCTION IS FEASIBLE. IT IS BOTH PRUDENT AND MORAL FOR THE UNITED STATES TO EXPLORE MEANS FOR ENDING THE DOMINANCE OF OFFENSIVE BALLISTIC MISSILE WEAPONRY.

MODERNIZATION -- CHEMICAL WARFARE. ADDITIONALLY, THE JCS FERVENTLY SUPPORT EFFORTS INITIATED IN THE FY 1986 BUDGET TO DEVELOP AN UPDATED DETERRENT CHEMICAL CAPABILITY. THIS PROGRAM IS NECESSARY TO OFFSET A SERIOUS DISADVANTAGE ON THE BATTLEFIELD AND TO COUNTER OFFENSIVE AND DEFENSIVE ASYMMETRIES STRONGLY FAVORING THE SOVIET UNION. FROM THE PERSPECTIVE OF THE AMERICAN FIGHTING MAN IN THE FIELD, IT IS DIFFICULT TO OVEREMPHASIZE THIS REQUEST.

MODERNIZATION -- GENERAL PURPOSE FORCES. I HAVE JUST RETURNED FROM EUROPE AND WAS ABLE TO WITNESS FIRST-HAND SOME OF THE MODERN WEAPONS AND EQUIPMENT WHICH HAVE COME INTO THE INVENTORY AS A RESULT OF INVESTMENTS MADE OVER THE LAST SIX YEARS. SIMILARLY, DURING MY TOUR IN THE PACIFIC, WE RECEIVED A STREAM OF MODERN WEAPON SYSTEMS. IT IS MOST IMPRESSIVE AND IS BENEFITTING ACTIVE, RESERVE AND NATIONAL GUARD FORCES ALIKE. MY FY 1987 POSTURE STATEMENT DOCUMENTS THESE ADVANCES IN SOME DETAIL. IT'S NOT JUST QUANTITY WE ARE ADDING BUT QUALITY AS WELL. TEST SCORES IN GUNNERY

AND BOMBING ARE STEADILY CLIMBING, IN GREAT MEASURE BECAUSE OF IMPROVED MUNITIONS AND FIRE CONTROL SYSTEMS FOR USE WITH TANKS, ARTILLERY, FIGHTER AND ATTACK AIRCRAFT AND SHIPS. HIGHER SPEEDS IN THE M-1 TANK AND BRADLEY FIGHTING VEHICLE HAVE PERMITTED A QUANTUM JUMP IN THE PACE OF OUR LAND WARFARE CAPABILITIES. IMPROVED RELIABILITY AND LESS TIME SPENT IN MAINTENANCE ARE CHARACTERISTICS OF THESE NEW WEAPON SYSTEMS WHICH EQUATE TO INCREASED CAPABILITY. SIMILARLY, RECENT INVESTMENTS IN AIRLIFT AND SEALIFT HAVE MATERIALLY ENHANCED THE ABILITY TO PROJECT POWER IN EVERY THEATER. I PERSONALLY WATCHED THE FAST SEALIFT SHIP (ALGOL) UNLOAD IN ANTWERP PORT A FEW DAYS AGO DURING EXERCISE REFORGER. IN SIX DAYS IT MOVED FROM NORFOLK TO WESTERN EUROPE 33,000 MEASUREMENT TONS INCLUDING 1,150 PIECES OF MAJOR EQUIPMENT. EVERYTHING WAS UNLOADED IN 21 HOURS. THE INTEGRATED AEGIS SYSTEM IS AT SEA AND EXCEEDING EXPECTATIONS IN MISSILE KILL CAPABILITY.

WHILE WE HAVE MADE GREAT PROGRESS OVER THE LAST SIX YEARS, IT IS ALSO IMPORTANT TO STRESS THAT WE ARE ONLY MID-STREAM IN THE CONVENTIONAL FORCE MODERNIZATION PROCESS. TO CITE SOME END FY 1985 FIGURES FROM THE ACTIVE ARMY, ABOUT:

-- ONE-THIRD OF OUR TANK BATTALIONS HAVE THE NEW M-1;

-- ONE-FOURTH OF OUR MECHANIZED BATTALIONS HAVE THE BRADLEY FIGHTING VEHICLE;

-- TWO-THIRDS OF AVIATION COMPANIES HAVE THE IMPROVED

BLACKHAWK HELICOPTER; AND

-- ONE-FIFTH OF THE AIR DEFENSE SAM MISSILE BATTERIES ARE EQUIPPED WITH THE NEW PATRIOT.

IN GENERAL, THESE MODERNIZED UNITS GIVE OUR PEOPLE A FAIR CHANCE TO DETER AND DEFEND IN AREAS WHERE THEY MAY BE "FIRST TO FIGHT" AS IN THE CENTRAL REGION OF NATO. BUT THOSE UNITS NOT MODERNIZED -- A MAJORITY OF ACTIVE ARMY BATTALIONS AND MANY IN RESERVE COMPONENTS -- REMAIN BEHIND THE POWER CURVE IN EQUIPMENT QUALITY, PARTICULARLY AS REINFORCEMENTS FOR NATO.

WITH RESPECT TO U.S. TACTICAL AIR FORCES, I FIND SIMILAR TRENDS. OVER THE LAST TEN YEARS, ROUGHLY TWO-THIRDS OF THE AIR FORCE'S TACTICAL FIGHTER SQUADRONS HAVE BEEN MODERNIZED WITH THE F-15, F-16, AND A-10. DURING THE SAME PERIOD, THE NAVY MODERNIZED OVER HALF OF ITS TACTICAL AIR SQUADRONS WITH SUCH TYPES AS THE F-14 OR F-18. FOR BOTH SERVICES, THIS MODERNIZATION PROCESS HAS NOT TRICKLED DOWN AS MUCH OR AS FAST TO THE RESERVES AS WE WOULD LIKE TO SEE.

OUR "BLUE WATER" NAVY ALSO IS ONLY PARTIALLY INTO THE MODERNIZATION PROCESS, PARTICULARLY WITH THE NEW AEGIS-EQUIPPED SHIPS WHICH WILL ADD PROTECTION TO OUR CARRIER BATTLE GROUPS IN TOMORROW'S SOPHISTICATED ELECTRONIC ENVIRONMENT AND HELP COMPENSATE FOR THE SOVIET NUMERICAL SUPERIORITY. ONLY 4 BATTLE GROUPS ARE NOW SO EQUIPPED. IN ADDITION, WE REMAIN MID-STREAM IN EFFORTS TO

MODERNIZE OUR NUCLEAR ATTACK SUBMARINE FORCE WITH ONLY 33 OF THE 688-CLASS IN A FORCE OF 96. IF WE ARE TO FACE THE FUTURE WITH THE CONFIDENCE THAT WE CAN REINFORCE OUR ALLIES, AS ON THE FLANKS OF NATO, OR KEEP SOVIET PRESSURE OFF THE SEA LINES OF COMMUNICATION THEN WE MUST PERSEVERE WITH THESE MODERNIZATION EFFORTS.

IN SUMMARY, WE HAVE MADE GREAT PROGRESS OVER THE LAST SIX YEARS UPDATING OUR CONVENTIONAL FORCES SO THAT THEY CAN SURVIVE ON THE MODERN BATTLEFIELD AND COMPETE WITH THE SOVIET THREAT OF TODAY AND OVER THE HORIZON. MORE PROGRESS WILL BE SEEN OVER THE NEXT TWO YEARS AS EQUIPMENT CURRENTLY IN THE PIPELINE REACHES OUR COMBAT FORCES. BUT IT SHOULD BE CLEARLY UNDERSTOOD THAT WE ARE STILL MID-STREAM IN THE MODERNIZATION EFFORT. TO FALTER NOW WOULD NOT ONLY STRETCH OUT THE ENTIRE PROCESS, BUT WOULD ERODE MANY OF THE GAINS ALREADY MADE AND, FRANKLY, PROVE MORE EXPENSIVE IN THE END. THE FY 1987 BUDGET RECOGNIZES THIS REALITY AND CONTINUES THE MOMENTUM.

TRAINING AND EXERCISES. NEW ACQUISITIONS HAVE BEEN COMPLEMENTED BY A RIGOROUS TRAINING PROGRAM DESIGNED TO CAPITALIZE ON THEIR ENHANCED CAPABILITIES: OUR EXERCISES ARE BRINGING TOGETHER ALL THE SERVICES AND INCREASINGLY INCLUDE NATIONAL GUARD AND RESERVE UNITS. OVER THE LAST YEAR, THE JCS SCHEDULED SOME 95 EXERCISES DESIGNED TO EVALUATE DOCTRINE, TACTICS, PROCEDURES, AND COMMAND AND CONTROL ARRANGEMENTS INVOLVING MULTISERVICE AND MULTINATIONAL COMPONENTS. CONCURRENTLY, OVERSEAS DEPLOYMENT

TRAINING BY ARMY RESERVE COMPONENT SOLDIERS IS UP BY NEARLY 50 PERCENT COMPARED WITH FIVE YEARS AGO.

LIKEWISE, WE ARE STRESSING MORE AND MORE THE LOGISTIC SIDE OF WAR FIGHTING. A FEW EXAMPLES ARE ILLUSTRATIVE. THE REFORGER EXERCISE IN WESTERN EUROPE RECENTLY TESTED EVERY ASPECT OF RECEPTION AND ONWARD MOVEMENT OF REINFORCEMENTS FROM THE CONTINENTAL UNITED STATES USING HOST-NATION SUPPORT FROM OUR EUROPEAN ALLIES. TEAM SPIRIT PERFORMS A SIMILAR FUNCTION FOR THE REINFORCEMENT OF KOREA. CENTRAL COMMAND'S BRIGHT STAR EXERCISE IS GROWING IN REALISM EVERY YEAR AND ENHANCING OUR ABILITY TO PROJECT POWER INTO THE MIDDLE EAST. THESE ARE JUST THE TIP OF AN EXERCISE ICEBERG. IN SUM, OUR TRAINING IS STEADILY BECOMING MORE JOINT, REALISTIC AND INNOVATIVE.

SUSTAINABILITY. OTHER IMPROVEMENTS CAN BE SEEN IN THE SUSTAINABILITY OR COMBAT "STAYING POWER" OF OUR FORCES. AS A SYSTEM, SUSTAINABILITY INCLUDES WAR RESERVE STOCKPILES (MUNITIONS AND SPARES), TRANSPORTATION CAPABILITIES, AND INDUSTRIAL SURGE CAPACITIES. WE WORRY ABOUT POTENTIAL "WAR STOPPERS" OR THEIR IMPACT ON THE THEATER NUCLEAR THRESHOLD. THUS, OUR GOAL IN SUSTAINABILITY IS "LOGISTIC SUPPORT TO OUR CONVENTIONAL FORCES FROM INITIATION TO SUCCESSFUL TERMINATION OF ANY CONFLICTS."

IN LINE WITH THIS GOAL, WE HAVE SEEN SUBSTANTIAL GROWTH IN U.S. EXPENDITURES FOR SUSTAINABILITY OVER THE LAST SIX YEARS. IN

THE PAST FOUR YEARS, THE FUNDING FOR AMMUNITION HAS GROWN BY OVER 25 PERCENT; SPARE PARTS FUNDING HAS DOUBLED; AND AMMUNITION INVENTORIES OF ALL SERVICES HAVE IMPROVED SUBSTANTIALLY. IN EUROPE, FOR INSTANCE, GROUND AMMUNITION TONNAGE IS UP 18 PERCENT, AND IT HAS ALMOST DOUBLED IN THE PACIFIC. MUNITION DEFICIENCIES WHICH PLAGUED US FOR YEARS ARE IMPROVING STEADILY, BUT AT THE CURRENT RATE OF EXPENDITURES, IT WILL BE SEVERAL YEARS BEFORE WE CAN NEAR OUR GOALS AND BREATHE EASIER.

THE FY 1987 BUDGET STILL PUTS CONSIDERABLE EMPHASIS ON SUSTAINABILITY AND RIGHTFULLY SO. BUT YEARS OF NEGLECT CANNOT BE REMEDIED EASILY OR QUICKLY. WE SIMPLY MUST STAY THE COURSE IF WE WANT A GENUINELY SUSTAINABLE FORCE AS WELL AS A MODERN AND WELL-TRAINED ONE. OTHERWISE, WE WILL BE SPENDING A GREAT DEAL FOR MODERN EQUIPMENT WITH ONE HAND AND THEN REDUCING ITS EFFECTIVENESS WITH THE OTHER.

SPECIAL OPERATIONS FORCES. A PARTICULAR WORD ABOUT "SPECIAL OPERATIONS FORCES" IS IN ORDER. WHILE SMALL IN TOTAL STRENGTH, OUR SPECIAL OPERATIONS FORCES HAVE ENORMOUS UTILITY AND VALUE IN PEACE, CRISIS, OR WAR. SOME ARE SPECIFICALLY TAILORED, DEDICATED, AND READILY AVAILABLE TO PROTECT AMERICAN LIVES AND PROPERTY OVERSEAS AGAINST INTERNATIONAL TERRORISTS OR OTHER NON-GOVERNMENTAL GROUPS HOSTILE TO THE UNITED STATES.

SOF UNITS ARE COMPRISED OF THE U.S. ARMY SPECIAL FORCES AND

RANGER BATTALIONS, U.S. AIR FORCE SPECIAL OPERATIONS FORCES AND THE U.S. NAVY SEAL TEAMS. MAJOR EQUIPMENT INITIATIVES IN TRAIN INCLUDE MORE HELICOPTERS WITH SPECIALIZED MISSION EQUIPMENT, IMPROVED AC-130 GUNSHIPS, AIR TRANSPORTS, LONG-RANGE COMMUNICATIONS, DRY-DECK SHELTERS ON SUBMARINES, AND SEAL DELIVERY VEHICLES, ALONG WITH RELATED SUPPORT FACILITIES.

OVERALL, THE PROGRAM REMAINS ON TRACK IN FY 1986 WITH:

-- AN INCREASE IN ARMY CONTINGENTS INCLUDING CH-47D HELICOPTERS AND RELATED SUPPORT;

-- EXPANSION OF THE NAVY'S SPECIAL WARFARE TRAINING SCHOOL AND NUMBER OF SEAL PLATOONS; AND

-- NEW EQUIPMENT ACQUISITIONS BY THE AIR FORCE TO UPGRADE THE SOF AVIATION SUPPORT FLEET.

SIMULTANEOUSLY, CONSIDERABLE THOUGHT HAS BEEN PUT INTO THE COMMAND AND CONTROL PROBLEM. I AM PERSUADED THAT WE NOW HAVE A SYSTEM WHICH GIVES US CONSIDERABLE FLEXIBILITY AND PERMITS US TO EXERCISE WHATEVER DEGREE OF OPERATIONAL SUPERVISION IS INDICATED BY THE CIRCUMSTANCES.

ESSENTIALLY, WE HAVE MADE REMARKABLE IMPROVEMENTS IN SOF CAPABILITIES AND READINESS SINCE THE EARLY 1980'S. I ALSO SUPPPORT THE INCREMENTAL APPROACH TOWARD IMPROVEMENT EMBODIED IN THE GENERAL SOF REVITALIZATION PROGRAM AND IN THE PARTICULAR FY 1987 SUBMISSION. MANY SPECIALIZED AND UNIQUE CAPABILITIES SIMPLY CANNOT

BE ACHIEVED ON A "CRASH" BASIS. THE PROGRAM WILL REQUIRE CAREFUL MONITORING AND MANAGEMENT OVER THE NEXT FEW YEARS TO ENSURE THAT VARIOUS COMPONENTS OF THE REVITALIZATION EFFORT REMAIN ON TRACK.

OVERALL CAPABILITY

OVERALL, THE WARFIGHTING CAPABILITY OF THE U.S. ARMED FORCES, ACTIVE AND RESERVE, REMAINS AT A HIGH STATE. KEEPING IT THERE REQUIRES US TO FOCUS ON TWO FACTS OF LIFE:

-- ONE, READINESS IS A COMPOSITE OF SEVERAL FACTORS: COMBAT EQUIPMENT, PERSONNEL, MAINTENANCE, EXERCISES, AND SUPPLY LEVELS. AS GENERAL GEORGE BROWN OBSERVED EXACTLY TEN YEARS AGO, NEGLECT IN ANY ONE OF THESE AREAS CAN STRESS SEPARATE PARTS OF THE SYSTEM WITH AN IMPACT ON OVERALL POSTURE. THE PROCESS OF DETERIORATION MAY SEEM GRADUAL, BUT THE BREAKDOWN IN CREDIBLE MILITARY CAPABILITY, SHOULD IT OCCUR, WOULD BE INSTANT.

-- READINESS DOES NOT DETERMINE BY ITSELF HOW WELL A FORCE WILL ACQUIT ITSELF IN COMBAT. A FORCE LESS THAN FULLY READY MAY DO VERY WELL. CONVERSELY, A 100 PERCENT READY FORCE STILL MAY NOT HAVE ADEQUATE MILITARY CAPABILITY BECAUSE OF QUANTITATIVE OR QUALITATIVE DEFICIENCIES IN FORCE STRUCTURE.

THE OBVIOUS CONCLUSION IS THAT FORCE STRUCTURE AND READINESS ARE NOT AN EITHER/OR PROPOSITION. WE NEED TO BE STRONG IN BOTH AREAS. THE PRESIDENT'S BUDGET FOR FY 1987 STRIKES SUCH A BALANCE.

SUMMARY AND CONCLUSIONS

IN SUMMARY, MR. CHAIRMAN, OUR MILITARY POSTURE TODAY IS DRIVEN BY A NUMBER OF REAL-WORLD DEMANDS, MANY OF WHICH HAVE EVOLVED OVER THE LAST 30 YEARS. IF ANYTHING, WE HAVE BECOME MORE RATHER THAN LESS DEPENDENT UPON GLOBAL PEACE AND SECURITY THAN WE WERE TWO OR THREE DECADES AGO. LAYERED ON TOP OF THESE DEMANDS IS A SOVIET THREAT WHICH HAS STEADILY INCREASED OVER TIME IN ALL DIMENSIONS OF MODERN WARFARE AND IN ALL OF THE REGIONS WHICH CONCERN US MOST. IN THIS ENVIRONMENT, I SEE NO SUBSTITUTE FOR PEACE THROUGH STRENGTH. FURTHER, I BELIEVE THAT THE PROSPECTS OF INFLUENCING THE SOVIET UNION TOWARD A CONSTRUCTIVE POSTURE IN WORLD AFFAIRS WILL DEPEND INEVITABLY UPON OUR CAPABILITY TO NEGOTIATE FROM A POSITION OF STRENGTH, BOTH TODAY AND OVER THE LONG HAUL.

BEYOND THESE STRATEGIC IMPERATIVES, THE PRESIDENT'S BUDGET FOR FY 1987 HAS SEVERAL OTHER MILITARY QUALITIES WHICH I SUPPORT:

-- IT STRONGLY EMPHASIZES THOSE CAPABILITIES ESSENTIAL TO U.S. SECURITY WHILE COVERING OTHERS WHICH ONLY WE CAN PROVIDE AS A SUPERPOWER AND AS A PARTNER IN GLOBAL SECURITY ARRANGEMENTS.

-- IT CONTINUES TO FLESH OUT ESSENTIAL IMPROVEMENTS IN OUR STRATEGIC NUCLEAR AND CONVENTIONAL FORCE STRUCTURE, ALONG WITH NEW INITIATIVES IN THE HIGH FRONTIERS OF TECHNOLOGY AND IMPROVEMENTS IN MILITARY COMPENSATION.

-- IT MAINTAINS A CAREFULLY CRAFTED BALANCE BETWEEN EQUIPMENT

MODERNIZATION, PERSONNEL READINESS, TRAINING AND EXERCISES, MAINTENANCE AND SUPPLY, AND SUSTAINABILITY.

-- IT PROVIDES THAT GROWTH NECESSARY NOT ONLY TO CONTINUE IMPROVEMENTS IN OUR MILITARY POSTURE BUT ALSO TO LEAD OUR ALLIES TOWARD A SIMILAR COMMITMENT OF RESOURCES. AND MOST IMPORTANTLY IT SENDS A STRONG MESSAGE OF DETERRENCE TO OUR ENEMIES.

THIS IS NOT TO SAY THAT THIS BUDGET ELIMINATES RISK. OUR CHALLENGES ARE MANY AND OUR ADVERSARIES ARE LARGE, POWERFUL AND DEDICATED. ON A TYPICAL DAY, WE HAVE ROUGHLY 475,000 SOLDIERS, SAILORS, AIRMEN, AND MARINES SERVING ON OR AROUND THE EURASIAN CONTINENT -- ESSENTIALLY WHERE OUR FORWARD DEFENSE COMMITMENTS ABUT OR OVERLAP THE FORWARD POSTURE OF SOVIET ARMED FORCES. WE COUNT ON THESE AMERICANS AND OUR ALLIES TO DETER IN A VERY HIGH THREAT ENVIRONMENT. WE ALSO RECOGNIZE THAT THEY MUST BE BACKED UP BY CAPABLE AND READY FORCES IN THE U.S. FOR BOTH DETERRENCE AND DEFENSE PURPOSES. YET, OVER THIRTY-FIVE BILLION DOLLARS HAS BEEN REMOVED FROM THE FY 1986 BUDGET FROM WHAT WE COUNTED ON JUST A YEAR AGO. THIS IS NEGATIVE REAL GROWTH OF ABOUT 6 PERCENT. DECREMENTS OF THIS NATURE REQUIRE SIGNIFICANT CHANGES AND REBALANCING. THE PRICE IN DEFENSE IS IN STRETCHING OUT AND INCREASING THE COST IN MODERNIZATION AND IN REACHING SUSTAINMENT GOALS. WE WILL ALSO GIVE UP MORE DESIRABLE LEVELS OF FLYING HOURS, COMBAT VEHICLE MILEAGE AND STEAMING DAYS. WE ARE HITCHING UP OUR BRITCHES AND TAKING A GREATER RISK. BUT THIS IS AS FAR AS I ADVISE WE GO. WE NEED A BALANCED PROGRAM THAT ALLOWS FOR SOME REAL GROWTH IN FY 1987. THE PRESIDENT'S BUDGET DOES THAT.

Chairman **Domenici**. Now I am going to list the Senators as I have them arriving. Andrews, Grassley, Kasten, Gorton, Quayle, Symms, Kassenbaum, on this side. Lautenberg, Sasser, Hart, Metzenbaum, Johnston and Exon. Oh. Sasser, Hart, Hollings. Yes; excuse me. I apologize.

DIFFERENCES BETWEEN AMOUNTS REQUESTED AND ACTUALLY APPROPRIATED

Admiral, would either of you prepare the following for us at your earliest convenience: If my numbers are correct, Mr. Secretary, and Mr. Chairman of the Joint Chiefs, the difference between the requested budgets that you sent up in 1982, 1983, 1984, 1985, and 1986, and what we actually appropriated, were seven—you do not need to write this down—$7, $15, $30, $39, and $88 billion, respectively, in each of the years.

If my arithmetic is right, that is $179 billion less, in budget authority that Congress funded, compared with what you asked for.

I wonder if you could, within the next week to 10 days, divide those reductions up into some understandable quantifiers, such as inflation, savings, program reductions, stretchouts—and if those have to be explained, give them to us—reductions of force, and anything that is objective for us.

Obviously, there are some that are qualitative, Admiral, but we are looking for those to which you can attach numbers. I would add one more, and if any others come to your mind, as you try to give us this list, put it in. I think we have ordered that you buy things and provide services that you did not request.

Admiral **Crowe**. Indeed.

Chairman **Domenici**. And the last appropriation was an interesting one, maybe $5 or $6 billion worth, then. So, would you add mandates of Congress that were not requested, if you do not mind.

Secretary **Weinberger**. We will do that, Mr. Chairman. There will be, as you say, inflation and fuel savings reductions, and there will be some cancellations, and there will be stretchouts, and there will be foregone salary increases for the troops—things of that kind, and we will show you what those consisted of.

[The following was subsequently supplied for the record by DOD:]

Congressional Adjustments to DoD Budget Requests

The following table depicts the difference between the amounts initially requested and the amounts actually appropriated to the Department of Defense for FY 1982-1986:

($ in billions)

	FY 82	FY 83	FY 84	FY 85	FY 86	TOTAL FY82-86
March Amendment 1981	221.8	254.5	288.9	326.2	367.2	1,458.6
TOTAL ADJUSTMENTS since MARCH 1981	**-8.0**	**-15.0**	**-30.7**	**-39.4**	**-88.8**	**-181.9**
Current Approved TOPLINE	213.8	239.5	258.2	286.8	278.4	1,276.7

These total adjustments are estimated to break into the following distribution between program and inflation:

($ in billions)

	FY 82	FY 83	FY 84	FY 85	FY 86	TOTAL FY82-86
Program	-4.0	-2.5	-7.4	-7.6	-39.4	-60.9
Inflation	-4.0	-12.5	-23.3	-31.8	-49.4	-121.0
TOTAL	**-8.0**	**-15.0**	**-30.7**	**-39.4**	**-88.8**	**-181.9**

Illustrations of types of program reductions identified in the table above, by fiscal year are as follows:

FY 1982:

- MilPers changes to the Survivors Benefit Plan (SBP)
- R&D strategic program reductions delay studies evaluating Air Force Long Range Combat Aircraft alternatives. Tactical program reductions delay the development of anti-submarine warfare programs, Navy fighter aircraft improvements, and Air Force cargo aircraft.

FY 1983:

- MilPers pay raise halved from 8% to 4% and DoD directed to absorb 25% of cost. Inhibited efforts to achieve force structure, leaving shortfall of approximately 6,700 personnel.
- Major strategic programs reduced include 9 PEACEKEEPER missiles, 6 TRIDENT I missiles, 1 TRIDENT submarine, 110 Air Launched Cruise Missiles, and 91 tactical nuclear Pershing missiles. Also reduced were, 21 SH-60B (ASW helicopters), 86 HARM missiles, 3 F-15 aircraft, Battleship reactivation advance procurement, 24 MK-48 torpedoes, and 64 Mobile Protected Gun System vehicles.

Congressional Adjustments to DoD Budget Requests (Cont'd)

FY 1983: (cont'd)

- Reductions to Army force modernization, flying hours, depot and ship maintenance, fleet modernization and other readiness reductions causing ship deactivation and deferred air wing activation.
- A 13% reduction in R&D technology demonstration projects decreased ability to evaluate technical feasibility of advanced concepts before entering development. R&D strategic program reductions delayed the development options for the Army Ballistic Missile Defense program and the development of a secure basing mode for the MX ICBM.

FY 1984:

- Funds reduced for ADP leases without sufficient funds added to procure leased equipment. Industrial plant equipment reduced, impairing our ability to perform maintenance efficiently.
- Aircraft reductions include 5 AV-8B light attack aircraft for the Marines, 2 EP-3 intelligence collection aircraft, 6 SH-2F anti-submarine warfare helicopters, 2 C-2 cargo aircraft, 38 T-34C trainer aircraft, and 12 Air Force F-15 air superiority fighter aircraft.
- Missile reductions include 6 PEACEKEEPER ICBMs, 85 PATRIOT air defense missile systems, 25 PHOENIX air-to-air superiority missiles, 15 HARPOON and 1,218 MAVERICK air-to-surface missiles.
- Other reductions include a TAO fleet oiler, a MCM mine countermeasures ship, and 176 Army Light Armored Vehicles.
- R&D tactical program reductions to JSTARS, Air Force Fighter Derivative, Alternate Fighter Engine, and the 155mm Howitzer Improvement program delay the introduction of these more capable weapon systems.

FY 1985:

- Military pay raise reduced from proposed 5.5% to 4%.
- Disallowed O&M increases requested for unemployment compensation, Army wartime host nation support and flying hours, and the Air Force asset capitalization program.
- Reduced MX and PERSHING missile systems; 1 TAGOS surveillance ship; and 1 TACS crane ship.
- R&D strategic program reductions to the Small ICBM, B-1B bomber, TRIDENT, and ASAT programs, jeopardizing our ability to meet the technical requirements and schedules of the programs.
- Reductions to SDI affect our ability to investigate the

Congressional Adjustments to DoD Budget Requests (Cont'd)

FY 1985: (cont'd)

- full range of technologies needed for a defense against ballistic missiles.

FY 1986:

- Cut 10,730 active military end strength and the related pay and allowances. Will require a rephasing of planned manpower increases to man the expanding force structure, particularly for the Navy and Air Force. Cut 10,000 full-time reserve strength personnel for management, administration, and recruiting.
- Reduction of 36 PEACEKEEPER missiles, PERSHING missiles and cruise missiles delaying modernization of our strategic forces. Reduction of over 7,000 TOW missiles affecting anti-armor capability. Reductions to AGM-130, MAVERICK and HARM missiles affect air-to-ground munitions. Other significant reductions include 90 air-to-air AMRAAM missiles, 2 MCM mine countermeasures ships, 2 TR-1 aircraft for tactical reconnaissance, 117 rolling airframe missiles, 300 CHAPARRAL air defense missiles, and 19 T-34C trainer aircraft.
- R&D strategic program reductions increase the risk of maintaining PEACEKEEPER, TRIDENT II, and B-1B testing schedules and delay development of the Strategic Conventional Standoff Capability and SRAM II missiles. Tactical program reductions in modernization projects, Advanced Tactical Fighter Engine Model Derivative, C-17, electronic warfare, and Classified programs delay the availability of technologically superior weapon systems.

In addition to congressional reductions to the President's budget, the Congress added programs that were not requested by the Department of Defense. Examples of these additions follow:

FY 1982:

- The Congress included special and incentive pays in the Uniform Services Pay Act above and beyond those requested by the Administration as well as strength improvements, reenlistment bonuses, skill retraining, and key personnel upgrades for military personnel. ($153.7 million)
- In the area of operation and maintenance, $80 million was added to Army Real Property Maintenance; $102 million was added to Navy general purpose ship operations; $32.9 million was added to Air Force depot maintenance. In all, $538.5 million was added to O&M funding.
- The Congress added $50 million for the procurement of Roland missiles, over $150 million for ammunition and

Congressional Adjustments to DoD Budget Requests (Cont'd)

FY 1982: (cont'd)

- small munitions, $27.3 million for a Landing Air Cushion Vehicle for the Army. $300 million was added to Navy shipbuilding appropriations for Coast Guard Acquisition
- and Construction. Air Force F-16 aircraft multiyear procurement funding was increased by $65.7 million; $35 million was added for LGM-30F/G MINUTEMAN II/III Mods; $250 million was added for special update programs under Air Force other procurement funding. Over $1 billion was added to DoD procurement programs.
- In the area of RDT&E, $37 million was added to Army funding for a remotely piloted vehicle; $19 million was added to Navy funding for Submarine Tactical Warfare Systems, $16.8 million for Fire Control System Electro Optics, $15 million for LHDX, $34 million for NAVSTAR, and a $100 million undistributed add. The Air Force received an additional $35 million for ALCM development, $51 million for Advanced Ballistic Re-Entry System, $32 million for AFSAT Communications System, $109.4 million for Classified programs, $28 million for Night Precision Attack, and $15.3 million for F-16 Squadrons. A total of $677.6 million was added to DoD RDT&E programs.
- In the area of Military Construction, $19.9 million was added for a Trainee Barracks at Fort Benning, GA; $18.6 millions for Barracks Modernization at Fort Dix, NJ; $25.1 million for a Pipe and Boiler Shop at Naval Station Mare Island, CA; $16 million for a Steam Distribution Line at Naval Station Charleston, SC; $12.4 million for a Depot Hydraulics Facility at McClellan AFB, CA; and $16.4 million for a hospital upgrade at Castle AFB, CA. Over $336 million was added to military construction funding for the Department. Another $16 million was added for Family Housing construction.

FY 1983:

- The Army's maintenance of real property funding was increased by $100 million; Navy flying hours were increased by $25 million, and real property maintenance by $30 million, while the Marine Corps was given an additional $20 million for real property maintenance and an $33.5 million for O&M shortfall; Army Reserve was provided an additional $9 million for unit equipment; and Navy Reserve was given an additional $8.7 million for aircraft mods. The Army National Guard received an additional $10 million for chemical defense equipment and $10 million for cold weather equipment. A total of $315 million was added to operation and maintenance funding in FY 1983.

Congressional Adjustments to DoD Budget Requests (Cont'd)

FY 1983: (cont'd)

- An additional $30 million was added to Navy aircraft procurement for KC-130R/T HERCULES and another $25 million for AV-8B VSTOL. An additional $33.4 million was added to Air Force aircraft procurement for other production charges. Over $100 million was added to procurement above requested levels.
- In the area of RDT&E, an additional $10 million was added to the Army's light Anti-Tank Weapon Test and Evaluation efforts; $15 million was added to Navy funding for MK-92 Fire Conrol System Upgrade; $28 million was added to Air Force funding for the Engine Model Derivative Program, $38 million for Military Strategic, Tactical and Relay System, $134 million for MX (CPA/BMD), and $60 million for Advanced Airlift Aircraft. Over $316.5 million was added to defense RDT&E efforts.
- An additional $13.6 million was added for a Crane and Equipment Maintenance Shop at Naval Station Charleston, SC; $11.1 million was added for RDJTC REDCOM Support Facility at McDill AFB, FL; $5.2 million was provided for an Armory for the Army National Guard in Boston, MA; $12.6 million was added for a runway, taxiway, and apron at Libby AAF, Ft Huachuca, AZ; and $10.5 million were provided for facilities at Stewart Airport, NY. Total additional funding provided for military construction projects was $67.4 million. An additional $20.6 million was provided for family housing construction, including rehabilitation of 160 units at the Aberdeen Proving Grounds and new construction at NATC Patuxent River, MD.

FY 1984:

- $325 million was provided for military personnel retention improvements.
- The Army was provided an additional $25 million for maintenance of fielded systems; the Navy received an additional $100 million for ship maintenance, $30 million for flying hours, $10 million for real property maintenance, and $18.3 million for LSD-28 operations. The Air Force was given an additional $15 million for aircraft damage repair and $8 million for Alaska LOGAIR. The Army Reserve received $20 million for unit equipment and $8 million was added for a shelter for the homeless. $28 million was added to Army National Guard O&M funding for selected reserve strengths. A total of over $395 million was added to defense Operation and Maintenance activities.
- The Army was given an additional $13.2 million for Nonsystem Training Devices; the Navy was provided an additional $58.1 million for EA-6B PROWLER procurement;

Congressional Adjustments to DoD Budget Requests (Cont'd)

FY 1984: (cont'd)

- the Air Force received an additional $405.3 million for F-16 aircraft multiyear procurement; and $300 million was provided for Acquisition and Construction, Coast Guard. Nearly $789 million was provided for procurement efforts beyond those amounts requested.
- The Army was given an additional $17.9 million in RDT&E funding for a Fighting Vehicle System and $15 million for UH-60A BLACKHAWK; the navy received an additional $8.4 million for helicopter development (AH-1T COBRA MC); and the Air Force was given an additional $50 million for the Engine Model Derivative Program. A total of $110.5 million was provided to defense RDT&E efforts above amounts requested.
- In the area of military construction, the Army was given an additional $9.8 million for construction at the Aberdeen Proving Ground, MD, and $23 million for Traineee Barracks at Ft Sill, OK. The Navy received $17 million for a TRIDENT Training Facility at Submarine Base Kings Bay, GA, $14.5 million for an Evaluation Testing Facility at NSSES Philadelphia, PA, $15 million for construction at Naval Station Charleston, SC, $12.2 million for an Applied Instruction Building, and $10.5 million for Electric Distribution System Modifications. The Air Force received an additional $11.7 million for a Coal Fired Heating Plant at Chanute AFB, IL; $8.6 million for two 250 person dorms at Whiteman AFB, MO; and $8.5 million for Unaccompanied Enlisted Personnel Housing at Fairchild AFB, WA. The Army National Guard received $2.9 million for construction at Camp Selby, MS. The Air national Guard received an additional $29.2 million for an Aircraft Beddown Facility at Stewart ANG Base, NY. A total of $415.9 million was provided in additional military construction funding. Further, an additional $100.7 million was provided for family housing.

FY 1985:

- $2.3 million was added to Reserve Personnel, Navy funding for increased drill participation rates.
- The Army was provided an additional $128 million for depot maintenance, $50.1 million for flying hours and flying hours maintenance support, and $300 million for readiness improvement package. Navy O&M was increased by $72 million for TAKX termination liability, while Air Force was given $25 million for aircraft component repair. O&M Air Force Reserve funding was increased by $56 million for JT3D Reengining. O&M Army National Guard was increased by $10.2 million for Chaparral support.

Congressional Adjustments to DoD Budget Requests (Cont'd)

FY 1985: (cont'd)

- O&M Air National Guard was increased by $17.2 million for JT3D Reengining and $9 million for C-5 Support. In all, O&M funding provided the Department received over $797 million not requested.
- In the area of procurement, the Army received an additional $44.1 million for AH-1S COBRA-TOW attack Helicopter funding, $24 million for C-12 and C-12D HURON funding, $28.1 million for 155mm, HE, COPPERHEAD Projectile, $401.9 million for war reserve ammunition, $33 million for mortar ammo, and $37.3 million for night vision goggles AN/PVS-5. The Navy received an additional $20 million for AIM/RIM-7 F/M SPARROW missiles, $77.6 million for CG-47 Advanced Procurement, and $50 million in sonobuoys. An additional $37 million was given the Air Force for F/RF-4 procurement, $288 for C-130H procurement, and $42 million for A-7 Mods. Finally, $380 million was provided for a consolidated National Guard and Reserve Equipment, Defense account. Total additions to procurement efforts totaled in excess of $1.6 billion.
- Army RDT&E funding was increased by $13.3 million for 120mm Mortar and $8 million for ARAPAHO. Navy RDT&E increased $10.2 million for F/A-18 Squadrons, $10 million for T-700 Engine/SH-2F, and $14.6 million for PENGUIN missile. Air Force funding increased $15 million for Advanced Airlift Aircraft (C-17) and $14 million for Autonomous Terminal Homing. In total, RDT&E funding increases totaled nearly $117 million.
- Army military construction funding of $17.8 million was added for Aberdeen Proving Grounds, MD, $10.2 million for Fort Jackson, SC, $38.8 million for Fort Hood, TX, $13.4 million for Fort Ben Harrison, IN, $13 million for Fort Drum, NY, and $38 million for Fort Bragg, NC. Navy funding was increased by $16 million for Naval Shipyard Pearl Harbo, HI. Air Force funding increased by $21.1 million for construction at McClellan AFB, CA, $9 million for Robins AFB, GA, and $27.5 million for Cannon AFB, ND. Military construction funding of $8.1 million was provided for the Army National Guard at Camp Selby, MS and $3.8 million for Akron/Canton Airfield, OH. The Air National Guard received $10.5 million for Stewart Airport, NY and $7.8 million for Jackson(AC Thompson), MS. In total, nearly $393 million was added for military construction projects not requested. Another $17 million was added for family housing projects not requested, including $15 million for Marine Corps Base, Camp Pendleton, CA.

Congressional Adjustments to DoD Budget Requests (Cont'd)

FY 1986:

- In the area of O&M, an additional $11 million was given to the Army for depot maintenance effort and $20 million for medical enhancements; $100 million was provided to the Navy for Coast Guard operations and training; $35 million was added to the Air Force for depot maintenance; and $30 million was added to Defense Agency O&M for quality assurance. An additional $20 million was added to Army National Guard funding for Armory operations and costs. Finally, a separate account was established at $379.1 million entitled Environmental Restoration Fund, Defense. Over $682 million was added for O&M related efforts.
- Procurement funding was added to the Army for the M113A2 Personnel Carrier ($40 million), $32 million for chemical demilitarization program, $25.6 million for the Advanced FA Tactical Data System,and $21.2 million for Combat Medical Equipment. The Navy received an additional $59.6 million for Mk-60 CAPTOR mines, $40 million for SIDEWINDER missiles, $148.9 million for MTSD advance procurement shipbuilding funds, $25 million for Strategic Sealift, $97 million for Cost Growth associated with shipbuilding programs, and $70 million for war reserve munitions. The Marine Corps received an additional $25 million for 155mm ammunition. The Air Force received $56.6 million for A-7 procurement, $15.9 million for F/RF-4 procurement, $200 million for Air Defense Competition, $50 million for HH-53 Aircraft, $50 million for Airborne Command Post Upgrade, $35 million for Drug Interdiction Aircraft, $38 million for SIDEWINDER missiles, and $40 million for war reserve munitions.
- Again in FY 1986, the Congress established a separate line item for National Guard and Reserve Equipment, Defense, with over $1.5 billion. $235 million was added for a new account entitled Coast Defense Augmentation. Nearly $3.4 billion was added for procurement efforts.
- In the area of RDT&E, $40 million was added to Army funding for medical research associated with AIDS. $19.6 million was added to Navy resources for the SSN-21 Combat System and $20 million fora Battlegroup Quick Reaction Surveillance System. The Air Force received $13.5 for Advanced Airlift Aircraft (C-17), $15 million for Pave Tiger, and $15 million for F-4 Air Defense. A total of $226.6 million was provided for RDT&E efforts in addition to funds requested.
- An ADP Management Fund was established with $100 million.
- Military construction funding of $7.5 million was added for construction at Fort Leonard Wood; $54.5 million for Naval Station New York, NY; $8.8 million for Keesler AFB, MS; and $12.5 million for Fairchild AFB, WA. A total of $163 million was added for various military construction projects.

Chairman **Domenici**. I just want to make one last observation, not by way of a question, but by way of a concern.

The budget that came up to us says that we are going to have to find, if we assume the President's economics, and the rest of those ingredients, $38 billion to get the deficit to $144 billion.

I wanted to stress publicly to you, Mr. Secretary, what I have stressed privately, and that is that we are in a whole new arena, in that budget authority, while it controls the programmatic detail, so as to speak, outlays have now become very important, because under Gramm-Rudman, sequestration is not predicated upon budget authority, but rather, upon outlays exceeding revenues and outlays over revenues exceeding that $144 billion.

OUTLAYS UNDERESTIMATED

I am truly disturbed because I believe that the estimate of outlays attributable to the defense request, based upon information that I received from my staff, and using some ratios that were used by the joint sequester team of OMB and CBO, I believe the outlays for the defense program are underestimated between $10 and $15 billion.

Now obviously, I am not suggesting that you made those estimates individually. It is OMB and your people that did it, and they did it probably in good faith, but I have reason to believe the outlays are $10 to $15 billion understated. Let me tell you how vital that is this year.

Frankly, in years past, that would escape everyone because the appropriations process, ultimately, did not care about that, and unless we made some real objection, it just went flying by. But this time, in August, when they take a picture of this budget, they will stop the fiscal policy for a moment and take a photograph of it, and they call that "Gramm-Rudman Sequestration Evaluation Time."

They will estimate outlays, and that is something that we really have to begin to understand, because at that point, it is the outlay estimate and not the budget authority that controls the sequester.

So let me tell you the dimension of that problem. If I am right, instead of $38 billion, without any other changes, you need $48 billion on the low side, $53 billion on the high side, to get to the targeted $144 deficit.

That, in turn, so everybody remembers the ratios, is reflected dramatically in budget authority, because if you are going to take it out of defense, you have got to put a two to one ratio to the outlays, because that is about what the BA to outlay ratio is in defense, as I recall. In the fiscal year 1986 sequester, it was about two to one budget authority to outlays, wasn't it, Mr. Secretary?

Secretary **Weinberger**. Well, it varies with accounts.

Chairman **Domenici**. I know. But overall?

Secretary **Weinberger**. Overall, roughly, but I have a few things I want to say when you are through.

Chairman **Domenici**. Oh, I am going to let you; indeed, I am going to. But that is a concern that I have. I hope I am wrong, but it does show you that we ought not quickly assess or assume that it is going to be very easy this year to find $38 billion, because it may turn out that we do not need $38 billion, we need $52 or $55 billion, and $38 billion is tough enough, because we have seen a budget that deals with $38 billion.

Now certainly you can explain, and then I am going to yield to Senator Andrews, first, on our side, and then Lautenberg, as I recall it, is next.

OUTLAY ESTIMATES ARE ALWAYS WRONG

Secretary WEINBERGER. Thank you, Mr. Chairman. Outlays are estimates. I do not think this gives me any special ability to speak about it, but just so you will know the background with outlays. I have been dealing with outlays since 1970, off and on, with a 5 or 6 year welcome interruption.

The problem with outlays is they are estimations. There is only one continuing, always, never-changing factor about outlay estimates. They are always wrong.

It is impossible for anybody to estimate outlays, 22, 24, 37 months ahead of time. You cannot do it. You have all of the historical ratios.

If you have a dollar and a half of authority, people will tell you that, for a certain account, you will have 76 cents of outlays. That is interesting, and it is nice to have the precedent, but it is not anything that anybody can ever rely on.

I think what your statements are based on is the fact that a historical computerized ratio run of the authority figures included in the defense request, has sometimes produced higher outlays than are listed there.

You are quite right: I did not make these outlay estimates up myself. We got them from this committee. We got them from the congressional resolution, the budget resolution that was adopted last August.

They told us the budget authority that we should come in with, as I mentioned before, was $314.7 billion. We came in at $311.6 billion, $3 billion under what we were told to do on authority.

This committee also told us in August what the outlays would be. They told us the outlays would be $276.7 billion, and when we went down the $3 billion in authority, we went down $2.4 billion in outlays, which is a little more than a lot of the historical sheets may show, but that is what we did, and we came in at $274.3 billion, which is the outlay estimate.

We took it exactly from this committee. Now there are a lot of factors, Mr. Chairman, that are new this year, which will change a lot of the computerized historical estimates, and, with your indulgence, I would like very briefly to run through about three or four of those.

Chairman DOMENICI. Let me first say, that my point is that if you were to make the miniscule $3 billion adjustment which you just explained, based upon changing times, nonetheless, the point I am making is that they are merely estimates and they vary a lot. Nevertheless, we are going to estimate them on a certain date, and we are going to sequester against them.

And consequently, maybe we will all have to be more accurate. We might not have been as accurate, when nobody cared about outlays when we were doing those budget resolutions. The appropriaters did not, anyway, until the end of the process.

Secretary **Weinberger**. Accurate or not, they were the ones we used and that you had given us.

FACTORS NOT IN COMPUTERIZED HISTORICAL SUMMARIES

But, let me give you a few things that are not in those computerized historical summaries from which these various estimates are made up. It is, as you point out, rather dangerous, Mr. Chairman, to have a full-scale set of sequestration actions start on the basis of some, I will have to say, certain to be inaccurate estimates of what outlays will be 27 months ahead of time.

But here are the new factors. The first new factor is of course Gramm-Rudman, and that has put a great deal more caution into the people who obligate against unobligated balances because they are not sure of what is going to be there, and they do not want to enter into contracts that will have cancellation penalties after that.

There is also a fund that affects outlays and that is the progress payment. I have reduced progress payments to contractors from 90 percent to 80 percent this last year.

That change will reduce outlays, it will slow outlays, and it will have its principal effect in 1986 and 1987.

The growth in our program this year is heavily reduced in procurement and support equipment areas, unfortunately, but it is, and those are areas that outlay more slowly.

So your historical averages are not going to be all of that much use. I am greatly reducing the services' use of unpriced contracts as part of an obligation tool, and that will reduce the outlays because they will have to get full contracts before they can start making the allocations against obligated totals.

Unfortunately, a great many people who have done work for us have been suspended because of our investigations and our audits, and that slows outlay, expenditures, and the entire process is time-consuming. The leadtime in obligations has increased because we have looked much more carefully at all of the vouchers coming in as a result of this heavy increasing audit, and we have much tougher audit procedures all the way through.

So what I am suggesting is that these new factors should be put into those computer-historical analyses of the relationship between authority and outlays. As you correctly point out, some extremely serious effects flow from an outlay estimate in August. I would hope that all of these new factors, at least as far as defense is concerned, would be ground into that, so that you would not order a sequestration that, 22 months later you may find out was totally unnecessary because the outlay estimate is high, based on a historical average that does not take into consideration all the new factors.

Chairman **Domenici**. We do have some latitude for the air, built into Gramm-Rudman-Hollings.

Secretary **Weinberger**. The final thing I should say, Mr. Chairman, is, that outlays are manageable.

Chairman **Domenici**. But the bell tolls sooner or later. We are worried about too much management of outlays, but we are anxiously awaiting to see if you are correct as compared with CBO, and I am sure they will take these new factors into consideration.

Secretary **Weinberger**. I hope so.

Chairman **Domenici**. Senator Andrews.

WARRANTY LEGISLATION WILL RESULT IN SAVINGS

Senator **Andrews**. Thank you, Mr. Chairman. Mr. Secretary, our challenge on this committee is to find where we can cut, cut the fat and not the muscle. It gets kind of tough.

Two or 3 years ago I introduced warranty legislation, requiring the Defense Department to get warranties on the new weapons systems they bought.

Is that going to result in significant savings, Mr. Secretary?

Secretary **Weinberger**. I think it will result in savings, yes, sir, because it will settle without litigation, in many cases, the obligation of the supplier to do whatever repair work may be necessary.

At the moment, because the warranty legislation is applied to weapons systems that have generally a minimum of 2 to 5 years for delivery, we cannot tell, because we are hoping the quality will be within the warranty and we will not have to use it.

But we will be able to give estimates, I think later on, as some of the warranties start coming into effect. But yes, I have high hopes it will make savings.

Senator **Andrews**. I recall that on the derivative fighter engine contract, which it was first applied to, sources I think quoted you or others in the Department saying you saved about $2 billion over the purchase of that.

Secretary **Weinberger**. That was the savings that we got because of the competitive nature of those contracts and we awarded—the winner of that particular competition was the one who gave us the best warranty, and that competition did result in a $2-billion savings on the engine contracts, and I think it is fair to say that warranties were an important part of that.

Yes; I believe they will save us money.

Senator **Andrews**. Well, Mr. Secretary, we appreciate those savings, and I have been a hawk for a long time. I have been voting for defense expenditures. I have many placks on my wall for supporting defense over the last 15 or 20 years.

The thing that is beginning to concern me now is that you should not have to be a darn fool to be a hawk in this business, and when the Defense Department comes before our committee with its "big rock candy mountain" budget, and threatens to hold its breath until it gets everything it wants—not everything it needs but everything it wants—it is time to think about probably reevaluating our position.

We all realize if we do not, we should; that the best national defense is a strong, resolute, well-educated, well-nourished healthy people.

This time, Mr. Secretary, the Defense Department, as never in the past, is tied to all other budget functions, and for far too long, some people, I guess, have failed to demand real accountability for a long-term defense strategy based on coherent and consistent policy, despite the billions of dollars that we have spent.

And some of the same people that rant and rage over spending for child nutrition, education, farm programs, and health programs, Mr. Secretary, seem to ignore their obvious value and benefit to the nation.

DEFENSE BUDGET RIPE FOR "DE-CAP"ITATION

I venture to say that—and backed op by the sources that we have to use in the Congress—that our defenses would remain strong and effective by cutting $30 to $35 billion from the defense budget, no matter the final numbers.

I think it is obvious the defense budget is ripe for perhaps necessary and long overdue—I hate to suggest it, coining a word, "de-Cap"itation—but we are not using, Mr. Secretary—and this thing bothers me—we are not using figures from "Mother Jones." We are using figures that come from the CBO. They come from the OMB.

And CBO estimates, as has been pointed out, that defense budgets in the period from 1983 to 1985 have included $23.2 billion more budget authority to cover future inflation than now appears to be necessary.

And the other analysts, the Comptroller-General, using different methods, have produced even higher estimates. How do we know who to believe? Where do we get in, Mr. Secretary—this is the confusing part to those of us who want to do the right job.

Secretary WEINBERGER. Well, Senator, there is no conflict here, and the "rock candy" that you spoke of came from this committee.

We put in our budget at $311 billion. You told us to put it in at $314 billion. So I do not think that we are subject to too much criticism on that score. We should not be.

Senator ANDREWS. In other words, Mr. Secretary, you submitted to the OMB request for $311.6 billion?

Secretary WEINBERGER. We submitted a budget of $311.6 billion which is here, and that is $3 billion under the $314 billion you told us to bring in in August.

Senator ANDREWS. That is the level that it went to the OMB?

Secretary WEINBERGER. The budget that is before you is the budget that the President signs, and that is the budget that is before you.

Senator ANDREWS. I know that, Mr. Secretary, but——

RISK TO NATION STILL THERE

Secretary WEINBERGER. It is $3 billion less than the one you told us to put in. But the point I want to know is, what has happened to change the risk to the Nation that you felt existed when you told us to put in $314 billion just last August, and I do not think that there has been anything but an increase in that. Now as far as who is right, and which figures to believe, yes, we budgeted because we budget, and guessed, estimate, 27, 28, 32 months ahead of time. We do estimate what inflation is going to be. We get that from OMB, and we get it from other sources, and we found that the President was able to control inflation a great deal better than anybody estimated, and we gave it back.

And that is the point that the chairman asked: What happened to that, what was done with that, and we are certainly going to give you that. I can give you——

Senator **Andrews**. But Mr. Secretary, when we talk about "rock candy mountains," I am talking about your budget item for 21 MX missile spares. What are you going to do? After we fire the first salvo, then we are going to run around if one of them did not work or one of them misfired, and try to find a spare?

Why do we need 21 spares for an MX Program?

Secretary **Weinberger**. Because that is the amount the military tell us are needed to have the number of tests to assure that you have a sufficient degree of reliability with the system, so that it will indeed be a credible deterrent, and we are deploying 50, and everybody knows, and the Congress authorized earlier, the number of additional ones for spares and training. And I will ask Admiral Crowe to respond as to whether that is excessive. You cannot have a weapons system, let it sit there, we hope forever, without ever having to be fired in anger, without testing it to make sure that you will not have to——

Senator **Andrews**. Well, we will examine that testing thing and my time has expired, and we will examine that in the defense subcommittee. But Admiral Crowe said one statement that I would like to get to, briefly.

COMMITMENT SERVES AS DETERRENT TO SOVIET UNION

You pointed out, Admiral, that in your tour through NATO, you find that our commitment to NATO serves, in your words, as a veritable anchor to their determination. A pretty heavy anchor, isn't it? We are spending $130 billion this year for NATO.

When you talk to those NATO nations, do you ever suggest to them that our contribution can only be valid as long as our economy stays valid, and with them keeping their tariff walls up, fencing our products out, how can our economy remain valid?

Admiral **Crowe**. Well, of course——

Senator **Andrews**. Should not they, as mutual defense partners, also become better trading partners?

Admiral **Crowe**. Of course, we suggest that all the time, Senator, and we recommend also that they spend more money on defense. We suggest that they keep a solid defense, just like we are arguing in front of this committee for, for this country. But you have got to calculate into this equation what you are getting for that. You are getting a forward defense; you are deterring the Soviet Union; you are doing all kinds of things for your money.

If you think this is a lot of money, Senator, the day deterrence does not work, this is going to be just a little drop in the bucket.

Senator **Kassebaum** [presiding]. Senator Lautenberg.

Senator **Lautenberg**. Thank you, Madam Chairman. Mr. Secretary, Admiral Crowe, welcome. This is the first time we have had a chance to meet under such circumstances.

I have looked forward to this opportunity. Mr. Secretary, in his budget message, the President speaks of steady, well-managed growth. Growth, yes, but I am a little concerned about the management.

SPENDING DOES NOT BUY SECURITY

Now more spending, I am sure you will agree, does not necessarily mean more security. We put a lot of money in and sometimes it leaks out the sides, in procurement problems, sometimes fraud. Sometimes, it spills over the top, because it cannot be spent fast enough. Now we are dealing with a third of the budget. I was very interested in your presentation.

The American people have cause to be concerned about how much of their resources are being spent and about the way it is done. They are concerned about what we are buying. To my way of thinking, we have not been buying security. To often we have been buying exotic weapons and I think occasionally destabilizing strategic systems, at the expense of conventional strength readiness, and without adequate conventional systems the use of strategic weapons becomes more likely in crisis.

Now a 12-percent increase in defense this year frankly cannot be accommodated based on other crucial needs. With a $202 billion deficit, the question is, where is the total security for our Nation? The deficit undermines our economic security, and our Nation's strength, of course, depends on that as well.

I recognize the work of my colleagues on armed services. I would like to focus on some aspects of Defense Department management and procurement.

I was struck by your comment about more auditors accounting for an improvement in systems, and pricing, and reduction of waste. I did hear you correctly, did I not, Mr. Secretary?

Secretary WEINBERGER. Yes, sir.

Senator LAUTENBERG. I mentioned this concern in our other hearings, when we talked about IRS staffing. The more people we have watching the store, the better the store is going to operate, usually. Well, one of the questions I have concerns cost-plus contracts. None of this is new to you, but contractors get reimbursed for reasonable overhead associated with contracts, that is, what someone thinks would be incurred by a prudent person in a competitive business. But are overhead costs reasonable? I have doubts, and let me tell you why.

WAGE RATES HIGHER FOR SKILLED LABOR

Wage rates among defense contractors are higher than competitive private sector rates. Is that true, Mr. Secretary?

Secretary WEINBERGER. Not overall, Senator. In certain areas where there is specialized or highly skilled labor for the technological lead that we have, and to maintain that with the high technology weapons that you spoke of, that we think we have to have, the wage rate is substantially higher, and that is why we had a special weapons deflator that enabled us to recognize that in trying to compute that.

But that is not true across the board. But there are higher wage rates in many aspects of defense contracting because it is highly skilled and sometimes quite scarce labor.

Senator LAUTENBERG. The Joint Economic Committee found that standard labor hours cost between $150 and $300, and much higher for a big weapons system. Is that a familiar statement——

Secretary **WEINBERGER**. Not that specific figure, but there are, as I say, depending on whether large or small weapon is not the important thing; it is the type of labor and the rate at which you have to compensate labor to get that kind of skilled labor that determines it.

And that is, without any question, higher than many other kinds of basic labor.

Senator **LAUTENBERG**. Right. But as we move further and further into the information era, we are all competing for those technological skills.

Secretary **WEINBERGER**. Yes; yes.

Senator **LAUTENBERG**. So that is something that concerns me. Overhead, as a share of cost, is higher among defense contractors than businesses in the nondefense sector.

Do you agree with that?

MANY THINGS ELIMINATED FROM OVERHEAD

Secretary **WEINBERGER**. Well, I think that it certainly is fair, that that used to be the case, Senator. We have examined overhead very carefully in recent years. I had some familiarity with it in the private sector, and I have been very concerned at some of the things that went into overhead, and we have, by changing regulations, eliminated a lot of things from overhead, and we have also done something, I think more important: We have moved to fixed price contracts, where the question of overhead becomes much less relevant, in fact irrelevant in many of them, if you have a firm, fixed price contract.

And we have moved much more toward that to the greatest extent we can. The whole problem here is that you do not step into one of these positions with a completely fresh slate.

There is a tremendous amount of backlog that has built up. You have a lot of contracts that have been signed, that play out over 4, 5, 6, 7 years, and you make as many changes as you can.

We have made a great many changes in what is allowable overhead now. But more important than that—and that was important to do—we are trying now, every time we can—and that is why competition is so important, to get fixed price contracts where the contractor is bound to it, and then he has to hold his own overhead down because we do not reimburse him.

Senator **LAUTENBERG**. I am told that overhead is as much as 150 percent, 200 percent of direct labor costs. Now I come out of the corporate world, as I think you know, and that strikes me as being an incredibly high figure, and the definition of what constitutes overhead, of course, has been subject to substantial scrutiny.

CHANGES COME WITH FIXED PRICE CONTRACTS

Secretary **WEINBERGER**. Well, that was part of the problem, that there was too much allowed into overhead, and not nearly a tight enough scrutiny of what was being claimed as overhead. That is one of the things our auditors and investigators did for us. As I say, yes, there is still some backlog from the past that we will be catching in our audits, but which has been corrected because we have changed the definitions, and changed the permissible things that can be claimed for overhead.

We have done one other thing that has had an extremely salutary effect. We require now a certificate, under penalty of perjury, that the amounts claimed for overhead are within all of our changed new regulation. That has slowed down of the submission of bills, and has caused a great deal of protest; but it seems to me that it is the kind of certificate that we require on the income tax, and it is the kind of certificate we require now.

So there were too many in the past, too many things being claimed as overhead to which they were not entitled. A great deal of that has been changed, and as we move to fixed price contracts, the question, as I say, becomes irrelevant.

Senator LAUTENBERG. Madam Chairman, what is the—are we—if we still have the Secretary and——

Senator KASSEBAUM. If we ever get through one round, I am sure there will be time for a second.

Senator LAUTENBERG. Thank you very much.

Senator KASSEBAUM. Thank you. Senator Grassley.

Senator GRASSLEY. Mr. Secretary, those overhead studies that you just referred to, would you share those with us?

Secretary WEINBERGER. To the extent that we are able to do so within the Privacy Act, and within the classifications, yes.

Senator GRASSLEY. That could be they are not available, but anyway, I would like to have you take a look at that because I am very much interested in those.

Mr. Secretary, I would like to start by quoting from a Washington Post Sunday Magazine article by former Secretary Laird. This was about the Republican Party.

He says:

> Our party has made some mistakes. I think we moved too far, too rapidly, with too much money in the defense area, and once you get the Defense Department with too much money you're gonna—and that's his words—you're gonna have a lot of things that embarrass the national security. You have to keep it a little lean and mean.

So I guess I would start off by saying that I think Mr. Laird, in using the phrase, "that Defense Department," apparently understands what I think a lot of people now are coming to realize: that too much money leads to higher prices and not more defense. And I am concerned about this from the standpoint of being a Republican. We became the majority party in this body 5 years ago, and I think we were successful in becoming the majority party because we Americans—or we led a battle that caused Americans to reject the economic stagflation of the late 1970's, when we tried, as a government, to solve all of our economic problems by throwing money at those problems.

The effort to stimulate that economy at that time led to printing money which was being pumped into the economy, and pumping up demand. Instead of getting results, we got higher prices.

We had a drop in incentive and we had a drop in economic output. Now, how that relates to the immediate problem before us in this budget, in the area of defense, is that we did not follow our own mandate when it came to defense in 1981.

When the Nation required a stronger defense, we did exactly the same thing in defense that we tried to do in the economy in the late 1970's. We threw money at the problem.

TOO MUCH MONEY CHASING TOO FEW GOODS

And now we have the same situation as we did in the economy under President Carter. We have got a defense policy of too much money chasing too few goods. We pumped up defense demand. We got higher prices and we got overhead, and we got a drop in incentives, and in defense output.

Your unobligated balances have also skyrocketed and I reached an unobligated balance figure of $67 billion, using your FAD tables.

Now your number seems to be $62 billion, but no matter whose number is correct, unobligated balances are four times higher than the historical average annual rate. And that is the same thing, really, what Senator Chiles was saying.

The question—or this questions the spending capacity of the defense industry, and this is what I want you to comment on.

This questions the capacity of the defense industry to spend the money that we have appropriated, and suggests that any growth at all in the defense budget will lead to even higher prices and higher levels of unobligated balances.

UNOBLIGATED BALANCES COST NOTHING

Secretary **Weinberger**. Well, I will try it again, Senator. Unobligated balances do not cost anybody anything. Unobligated balances are the function of full funding of programs, which is the only proper sensible way to go in budgeting.

And when you get the full funding at the beginning, as you should, so you will know the total cost, then you have the problem of, do you spend it all in 1 year or the first 6 months? And you do not, if the bills are not in.

You do have it ready to spend as the bills come in, and you have better than that, the ability to enter into contracts that give you much lower costs, and that is how we were able to get two carriers for a savings of over a billion dollars, and we will continue to do that just as long as the Congress will continue a sound policy of full funding at the beginning, of what these projects cost.

If indeed we are able to bring in projects lower than the actual estimate of the authority required, that authority is returned to the Treasury, or we ask you to reprogram it for something else, such as salaries or anything else, of the troops.

So the fact that there is an unobligated balance simply means that the Congress has been fully funding the programs, as opposed to funding them year after year, requiring infinitely higher cost.

And the fact——

Senator **Grassley**. Mr. Secretary, but Mr. Secretary——

Secretary **Weinberger**. The fact that there is a high unobligated balance is not a matter of criticism. It is a matter of praise for the Congress to fully fund the program, and a matter of praise for the Department that it is spending them in a prudent way.

As far as comments from some newspaper about what——

Senator **Grassley**. Well, I am not asking you to comment on that.

Secretary **Weinberger**. Well, I thought I should because you commented on it, and those comments are——

UNOBLIGATED BALANCES GROW TO HISTORICAL LEVELS

Senator **Grassley**. What I want to do, Mr. Secretary, is to tell my colleagues where I think that you are wrong, and that the ball is in our court now. The fact is that in the defense industry, the feedback variable for knowing when the defense budget is overfunded has to be the growth—now the growth, not just the figure—but the growth of the unobligated balances, especially against what is projected.

Now, I said to you that we had this $62 billion figure, using the Department's figure, or $67 billion using my figure. But that figure was projected to be just $51.6 billion by the end of the year, and it has jumped that much already.

The average annual level of unobligated balances, to emphasize what Senator Chiles said, has been $16 billion.

Now that is over three decades. Then all of a sudden, when we start pumping up the budget, we thought unobligated balances would rise in proportion to the increase to the investment accounts. But our projections, of course, have been way off. The balances have quadrupled compared to the historical level and they are getting larger, and that is the point. And that is what we have to deal with in this committee, because we get the same answer from the Secretary.

Secretary **Weinberger**. Well, let me try it the fifth time. Now the fact that the unobligated balances grew beyond their historical level is because you started funding, quite correctly—I am speaking of the Congress now, not you personally—started fully funding programs, and it is a very good thing that you did because when you partially fund programs, you cannot get any kind of an economic rate of acquisition.

When you fully fund programs, which is what we urged you to do, and what you are doing, then you do have unobligated balances which do not cost anybody anything, save a lot of money in the long run; but it gives you the ability to contract for the full weapons system, and then you pay it out as the bills come in.

And that is all an unobligated balance is, and when it is too much because we have saved a lot of money, it goes back to the Treasury.

Senator **Grassley**. Just one sentence, Mr. Chairman, and count the words. He is saying what way he feels it is. I mean, the way he thinks it is supposed to be. I am telling you the way it is. That is the difference.

Chairman **Domenici**. That was two sentences. [Laughter.]

Senator Sasser, you are next on my list. I wonder if you, and the Senators who follow you, on both sides, could indulge me to let Senator Symms take 2 minutes. He has a particular question that he wants to ask and he must be somewhere.

Senator **Sasser**. Well, I would be glad to defer to Senator Symms for 2 minutes.

Senator **Symms**. I do not want to crowd out my colleagues.

Chairman **Domenici**. A couple of minutes?

Senator **Symms**. Well, that would be great.

Chairman **Domenici**. Why don't you do that, then.

Senator **Symms**. I have two questions, Mr. Secretary. First off, let me say that I compliment you on some of the reforms that you are trying to do in fixing some of these glaring problems that we have had in our defense procurement, and I wish you well to get it fixed even better.

NEW RIFLE GETTING HIGH PRIORITY

One thing that really does concern me, however, with this defense buildup, is the basic infantryman's equipment, and I find it incredible, that we have not yet reequipped the Army with the M-16A2 which I like to refer to as the M-17, because for us laymen, I think it is a lot easier if you just change the nomenclature.

Secretary **Weinberger**. Right.

Senator **Symms**. But when are we going to get the new rifles for the Army, including the SQUAD automatic weapon?

Secretary **Weinberger**. We are getting it, Senator. It is being issued now and the Army divisions are being equipped with it as rapidly as the funding permits, and it obviously takes its place with a lot of other very high-priority programs, but I have to tell you—I cannot say in all confidence here in this room—but I have to tell you that as an old infantryman, it is getting a higher priority from me than perhaps it would otherwise.

But we are equipping the Army with it; the Marines developed it. It is a splendid rifle, and I agree with you completely, and the more rapidly we can do it the better I would like.

I can get you—I do not have it right with me now—I can get you the percentage of units that are equipped with it now, and the schedule.

[The following was subsequently supplied for the record by DOD:]

NEW RIFLE

The Marine Corps received the first M16A2 rifles in May 1984 and now have over 100,000 of the new rifles on hand which equates to approximately 50% of their total requirement. All Marine Corps units will be fully equipped with the M16A2 rifles by November 1986. The Army will begin to receive the M16A2 in August 1986 and Army fielding is projected to be completed by June 1989.

The Marine Corps has fielded SAWs in their Active Infantry units and are now in the process of fielding the weapons in their Infantry reserve units. All Marine Corps SAW requirements are projected to be filled by December 1989.

The Army has issued SAWs to the training base, the 82nd Airborne Division and the 75th Ranger Battalion. The remaining SAW distribution within Army will be synchronized with distribution of the M16A2 rifles and sufficient assets are projected to be available to accomplish this synchronized fielding.

Senator **Symms**. I would appreciate that. And then second, the SQUAD automatic weapon, how about that? That is being——

Secretary **Weinberger**. Yes. Yes, sir.

Senator **Symms**. That is coming in for the Army now?

Secretary **Weinberger**. Yes, sir.

Senator **Symms**. Good. Thank you. And one last question. Are we really going to tear up these Poseidon boats?

Secretary **Weinberger**. Senator, I would like to be able to talk to you frankly about that in an open hearing, but that is a matter that I have been asked to make recommendations on for the President. I have done that.

I do not ever discuss my recommendations to the President with anyone else but the President, and I guess on that one, I just have to wait till a decision is forthcoming.

Because I have always followed that policy, that I just feel I should not discuss conversations or recommendations I make to him at his request.

Senator **Symms**. Thank you, Mr. Chairman and my colleagues.

Chairman **Domenici**. Senator Sasser. Thank you very much, Senator Symms.

Senator **Sasser**. Thank you, Mr. Chairman.

Mr. Secretary and Admiral Crowe, I want to welcome you to the committee and say that we look forward to your service as Chairman of the Joint Chiefs of Staff.

Admiral **Crowe**. Thank you, Senator.

Senator **Sasser**. I think you will serve honorably, and well, and I am pleased to see you in that post. I sometimes think that, Mr. Secretary, when you are testifying before this committee, and my colleagues are asking you questions, and we are presenting our views, I am reminded of the old fable of the five blind men who were examining an elephant, and the one who felt the elephant's leg described the elephant as a great tree.

And one felt of his trunk and described it as a wiggling snake, and I forget what other parts of the anatomy the other blind men touched, and how they described it. It is probably a good thing I cannot remember.

Now let me just follow on with something that the Senator from Iowa was discussing a moment ago. You know, historically—I think we ought to see this defense budget in historical terms, and historically, we have increased defense spending since the late 1970's.

In the previous administration there was an agreement with our NATO allies that we would increase defense spending, in conjunction with them, at 3 percent per year in real terms, and that did take place in 1978-79, and also in 1979-80, according to my figures.

Now we, it appears to me, argue with you, Mr. Secretary, really around the edges of the defense budget.

We have appropriated over the past 5 years 96 percent of the funds that this administration and the Department of Defense has requested, according to the figures that I see.

So we are really not arguing, I think, about the main thrust of defense, and we are really not arguing about the question of whether or not we need to maintain an adequate defense or increase defense spending, even.

OVERSEAS CONSTRUCTION INCREASING

But I become concerned when I see things—for example, on the Military Construction Subcommittee on which I serve—the Department of Defense is proposing a 40-percent increase in the amount of construction that we undertake overseas.

This comes on top of a 120-percent increase in overseas construction over the past 5 years. This comes in the face of our NATO allies not living up to their commitment to increase defense spending by the 3 percent in real terms.

None of them have complied with that. Perhaps Canada has. Britain did for a while. Now we are confronted with West Germany which has not complied with it, and this year are discussing entertaining the possibility of decreasing their defense budget.

And here we are sitting here, almost a half a century after the Second World War, maintaining 250,000, one-quarter of a million men in Europe, and my question is, when are we going to get our allies to do more? What can we do to get them to do more? It appears to me that as we increase our defense commitments, conversely, they decrease theirs, and when Senator Nunn takes the floor and tries to send them a message by a potential cut in our NATO manpower commitments, the Department of Defense comes to us and says, no, no, we must not do this. This is going to disrupt our whole alliance in Western Europe.

What can we do to make them do more? And do you not think they ought to be doing more?

Secretary **WEINBERGER**. Senator, no nation in the world, of our allies, is funded at minus 6.3 percent. We are. And that makes it extremely difficult to urge anybody to do any more.

Of the NATO nations, the NATO average is 3.6 percent. You are quite right about England and Germany. They have, after 2 or 3 years of much higher spending, have gone down.

Japan is the only nation in which defense increased. The only increase they have had in their budget in the last 3 years has been for defense.

They also provide over $1 billion, and other things tbat do not appear in their budget. Nobody is doing enough. I am not saying they are doing enough.

They are doing much more than we are, right now, on a proportional percentage basis, which seems to be the only way we measure these things. On the military housing overseas, I would like to take full responsibility for that.

I have had the opportunity to visit our troops in a number of parts of the world, and I might say it is the best part of this whole job because when you visit them and see their morale and their pride, it is an enormously encouraging thing.

IMPROVE HOUSING CONDITIONS

But in the course of doing that I have seen some pretty dreadful housing conditions overseas, and I have urged repeatedly, that we try our best, one way or another, to improve those. We did last year and we have more in the budget this year.

Housing in Germany has not been satisfactory; housing in the Philippines has not been satisfactory. It is important that we keep those troops there in all those places because that is the best way to defend the United States.

So we have had that kind of an increase in military housing because we urgently need it. General Vessey had a very colorful phrase.

He said that the housing that he saw in parts of Europe would have been rejected by the Hessians because it was built shortly before they came over to the United States to help us in the revolution. It was not quite that bad but it was not very good, and we have improved it very greatly now. On the military spending of our allies, I do not think we have very much of a leg to stand on on proportionate increases this year. But we certainly will continue to urge them to bear their share of the burden, because it is vital to them and it is vital to us.

And so at every NATO meeting—and I go to at least four a year—we make every effort to make that point. But it is getting increasingly hollow, when the United States funding goes down minus 6.3 percent in this current year.

Senator **SASSER**. One quick question. My time is up. You and I do not agree on those numbers you just came up with, Mr. Secretary, but I will not pursue that.

MILITARY REFORM BILL PROPOSED

The Armed Services Committee has initiated a markup on a defense or a military reform bill including changes in the organization of the Joint Chiefs of Staff.

The House has already approved a so-called reform bill, so it looks like 1986 is going to be the year of defense reform. I would like to ask you, Mr. Secretary, both you and the Chairman, do you support congressional proposals to change the structure of the Joint Chiefs of Staff?

Secretary **WEINBERGER**. Well, I have sent to the Armed Services Committee, Senator, a letter which represents the views of the Department, and mine, with respect to various kinds of changes that could be made, supporting some, opposing others, and that is before them in connection with their markup.

I do not know if you would describe those things I have mentioned as supporting reorganization of the Joint Chiefs, or not. I think there are two or three changes that would be quite useful. Admiral Crowe obviously will speak for himself.

Admiral **CROWE**. Senator, we were likewise a part of the input which the Secretary sent in in terms of comments on the senatorial draft legislation, but all the Chiefs of Services likewise commented in letters to the committee.

And I think it is fair to characterize them much as the Secretary did: Yes, we agreed with some things; we disagreed with others that were proposed.

Chairman **DOMENICI**. Thank you very much.

Senator **EXON**. Well, let's clarify that. On balance, I mean on balance, I have read your responses and I have listened to your testimony.

Chairman **DOMENICI**. Senator Exon, did you want to be recognized? I am glad to do that. Go ahead.

Senator **SASSER**. I will yield to the Senator.

Senator **EXON**. Would it be fair to say that neither one of you are very enthusiastic about the proposal, is that not right?

SOME ORGANIZATIONAL CHANGES SUPPORTED

Secretary **Weinberger**. I do not think that is a fair description, Senator; no. I think that we—I, speaking for myself—have a certain skepticism about whether straight organizational changes are going to improve substantially a system which presently is working quite well. But we certainly are examining the suggestions made by the committee. We have joined in supporting many of those, and we would continue to support them.

Admiral **Crowe**. Senator, could I comment on that just a moment?

Chairman **Domenici**. Indeed.

Admiral **Crowe**. I think it is fair to say that from the standpoint of the Joint Chiefs of Staff, the proposal that came out of the committee report to replace the Joint Chiefs of Staff with a thing called the JMAC, we were against uniformly, consistently, and unanimously.

I think that some of the other suggestions, though, the Chiefs were very positive on. We commented this week because we saw a draft of proposed legislation which we felt went further than we had seen before, and we were for some suggestions; we opposed those that seemed to be threatening the corporate character of the JCS.

Secretary **Weinberger**. I wonder if I could ask Senator Sasser which was the elephant and which were the five blind men?

Senator **Sasser**. Mr. Secretary, I am not sure either.

Chairman **Domenici**. Senator Gorton, I think on my list you were next.

STUDY ON UNOBLIGATED AND UNEXPENDED BALANCES

I wonder if you would let me make one observation even though Senator Symms is not here, excuse me, Senator Grassley is not here, I am going to repeat what I said yesterday and I am sure that Senator Chiles, whom I have spoken to, will agree with this. I am going to pick a time with enough advance notice so that Senator Grassley at least will have time to be here, and anybody else who wants to. We will have plenty of notice. I have asked our joint staff to prepare a document on what unexpended balances and unobligated balances mean? What they have been historically, and what they do to contribute to the defense, growth in defense and whether they are the cause of some excessive spending?

We would also ask that the staff, in doing that, confer with whatever experts that they need. I note that one of our former staff members is now comptroller. He is here, Bob Helm. He is the comptroller of the Department of Defense. I would assume that the staff would talk with him, not by way of accepting anyone's views, but I do believe he can help. It is not as simple as the statement that Senator Grassley made in his conclusion and I hope that we will understand it and then we can draw some conclusions from it. We ought to do that.

Senator **Hollings**. Mr. Chairman, if you would yield?

I would like to point out the difference between unobligated balances and unexpended balances. I am afraid that the Secretary's answers are addressed to unexpended balances, which refer to money on hand to pay the bills.

Unobligated balances are just what they sound like; they have not been obligated and therefore not sitting there to pay a particular obligation.

Secretary WEINBERGER. We cannot obligate, Senator, until we have a contract that is for a particular piece of work on a total program. When we have that signed and the work is to proceed, we are obligated.

Senator HART. Well, your figure there for 1985, or 1986, that is this year, $62.6 billion unobligated but $270.6, I think that your comptroller gave us is the unexpended balance. $270.6 billion.

And I think that ought to make that difference.

Chairman DOMENICI. I think that we ought to prepare this paper to answer everyone's questions, because I do not want the paper being worked on and then somebody saying, "well you answered the wrong issue." Let us have that study on unobligated balances and unexpended balances, and do all of the comparisons and create a set of propositions that will let us understand their relevancy with reference to the issues that Senator Grassley has raised and Secretary Weinberger has indicated that he disagrees with, here, today.

So, we will do that and we hope that you will help us.

Secretary WEINBERGER. We certainly will.

[The following was subsequently supplied for the record by DOD:]

BUDGET EXECUTION

IN THE

DEPARTMENT OF DEFENSE

FEBRUARY 1986

Program Execution
in the
Department of Defense

The process of budget execution within the Department of Defense is a multi-faceted process. It is also, however, a complex process. Consequently, it was suggested that DoD put together a briefing to make the process of budget execution understandable. This paper, then, roviews the process within the Department and the safeguards it employs to ensure that the results indeed reflect the intent of the Congress in approving DoD resources.

The subject of unobligated and unexpended balances is often discussed but frequently misunderstood. "Unobligated and unexpended balances" sometime assume a subjective quality they really shouldn't. They assume a life of their own, but once the process of program execution is understood, it becomes clear that unobligated and unexpended balances are merely an arithmetical derivative that reflects what is happening as the program is executing. They exist, in part, because of good management practices employed by the Department, including the congressionally supported practice of fully funding defense programs at the time of first authorization and appropriation of funds.

The Execution Process

The execution process itself is very much event oriented.

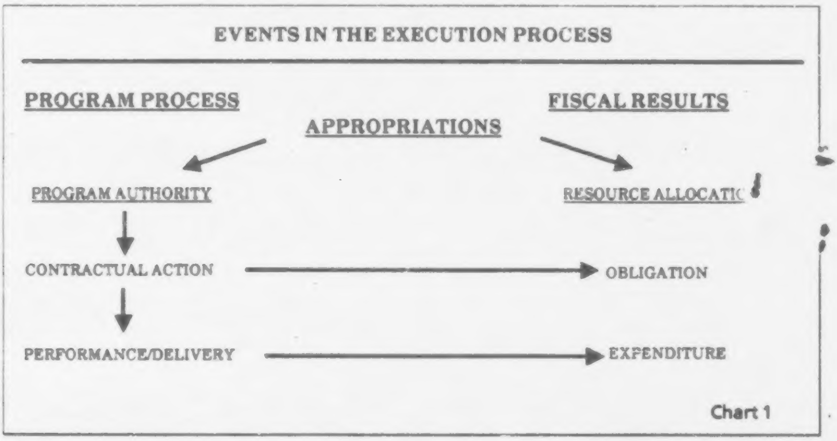

EVENTS IN THE EXECUTION PROCESS

Chart 1

In the legislative process the Department of Defense is provided with both the authority to proceed with programs and the resources necessary to do so. Authorization and appropriation legislation provides a clear understanding of the intent of the Congress as the Department executes defense programs and enters into contracts either for personal services or for material. When those contracts are signed, an obligation is recorded and, as performance is rendered or delivery of material occurs, an expenditure takes place. That, simply stated in the most macro sense, is the process of execution, and if it all occurred entirely in a single fiscal year, there would be no such thing as an unobligated balance and, indeed, practically no unexpended balance.

But it doesn't occur all in a single fiscal year because of the different character of programs and appropriations with which we deal.

TIME PHASING OF THE EXECUTION PROCESS

OPERATIONS
- 1 YEAR APPROPRIATION LIFE
- 100% OBLIGATED IN 1ST YEAR
- 75% EXPENDED IN 1ST YEAR

R&D
- 2 YEAR APPROPRIATION LIFE
- 92% OBLIGATED IN 1ST YEAR
- 49% EXPENDED IN 1ST YEAR

PROCUREMENT (EXCL. SHIPBUILDING)
- 3 YEAR APPROPRIATION LIFE
- 76% OBLIGATED IN 1ST YEAR
- 16% EXPENDED IN 1ST YEAR

SHIPBUILDING
- 5 YEAR APPROPRIATION LIFE (7 YEAR APPROPRIATION LIFE PROPOSED FOR FY 87)
- 60% OBLIGATED IN 1ST YEAR
- 5% EXPENDED IN 1ST YEAR

MILITARY CONSTRUCTION
- 5 YEAR APPROPRIATION LIFE
- 75% OBLIGATED IN 1ST YEAR
- 13% EXPENDED IN 1ST YEAR

Chart 2

This is a composite historical average in each budget title. Because of this time phasing aspect, balances will exist as the program execution takes place.

If there were only operating programs, such as those that provide salaries or utilities at our bases, there would be no unobligated balances and very little unexpended balances. But, there are also programs that finance long term capital investments and that is where it becomes clear that this execution process is time oriented and does not occur in a single fiscal year, nor should it. Congress has recognized this by providing varying life spans, or periods of availability, in each of the functional areas.

Procurement appropriations, for example, are available for three years, except for shipbuilding, which is available for five years. Military construction is also available for five years.

On the average, when the many, many appropriations involved are considered, obligations and expenditures occur at the percentages presented here in the first year.

For example, in the procurement area, approximately 75 percent of all of the procurement appropriations are obligated in the first year. However, when the individual accounts, like Missile Procurement or Other Procurement, are examined, first year obligations will vary.

DEPARTMENT OF DEFENSE BUDGET
MILITARY FUNCTIONS
UNOBLIGATED AND UNEXPENDED BALANCES AS OF SEPT 30
($ BILLIONS)

	1982	1983	1984	1985	Est. 1986	Est. 1987
UNOBLIGATED BALANCES	34.6	43.4	51.6	61.5	59.9	60.3
OBLIGATED BALANCES	107.6	128.7	153.5	182.8	202.5	239.4
UNEXPENDED BALANCES	142.2	172.1	205.1	244.3	262.4	299.7

Chart 3

The numbers on this chart are impressive. At the end of fiscal year 1985, the Department had actual unexpended balances of $244.3 billion.

It's important, when addressing that amount, to recognize that more than three-quarters represents amounts that are actually under contract for material or personal services, so nearly 75 percent is actually obligated and is simply awaiting the performance or delivery of material that will result in the expenditure.

About 25 percent is unobligated. This might be a modest share of the total, nonetheless, it is recognized that $61.5 billion is a lot of money. It's a legitimate area of concern and one to be looked at and clearly understood. These figures represent the amounts yet put under contract, not only from the budget year appropriation request, but carryover balances from prior years. A specific weapon system is presented as a case study to illustrate how unobligated balances do extend over a period of time.

Unexpended balances, simply stated, consist of amounts that are under contract but not yet billed by contractors, as well as amounts that are not yet under contract. If it is accepted that awarded contracts are legitimate and the work is taking place, then focus is appropriately on the amounts that have not yet been placed under contract or have not been obligated and the circumstances that cause that condition. Looking at the $61.5 billion from the previous chart, then, most of the unobligated balances would relate to procurement or capital investment programs, where the Congress has recognized in the appropriation life span that there is a time phased aspect to program execution.

DoD UNOBLIGATED BALANCES
End of Fiscal Years 1982 - 1986
($ Billions)

	1982	1983	1984	1985	Est. 1986	Est. 1987
PROCUREMENT	25.6	33.5	39.9	46.1	45.7	46.9
RDT&E	1.4	1.7	2.7	3.3	3.9	4.9
MILITARY CONSTRUCTION	3.1	3.7	3.9	3.8	3.2	3.7
FAMILY HOUSING	.3	.3	.3	.4	.4	.5
INDUSTRIAL FUNDS	2.4	2.0	3.1	5.8	6.0	3.6
STOCK FUNDS	.1	.5	*	*	*	*
OTHER	1.7	1.7	1.7	2.1	.7	.7
TOTAL UNOBLIGATED BALANCES	34.6	43.4	51.6	61.5	59.9	60.3

* Under $50 Million

Chart 4

Thus, most of the unobligated funds are financing the aircraft, missiles, ships, and tracked combat vehicles where the appropriation lives are three to five years.

The category identified as "Other" represents balances resulting from foreign currency fluctuations or occurring in the remaining revolving and management funds and various defense trust funds.

Research and Development and Military Construction balances are modest.

Procurement Unobligated Balances

Obviously there has been a significant increase in the unobligated balances for the procurement appropriations over the years, and these balances increase largely as the program itself increases.

For other appropriations, unobligated balances vary depending on the nature and size of the program. Within the procurement title, the Navy shipbuilding program accounts for the largest single portion of the unobligated balances. A comparison of unobligated balances to program value each year, exclusive of shipbuilding, indicates that the relationships are fairly stable and reasonably predictable. The point is that the large infusion of procurement dollars of the last few years will not necessarily result in long term disproportional increases in unobligated procurement balances.

PROCUREMENT APPROPRIATIONS
UNOBLIGATED BALANCES AS OF SEPTEMBER 30
($ MILLIONS)

	1982	1983	1984	1985	Est. 1986	Est. 1987
Aircraft, Army	419	661	821	1,015	862	889
Missiles, Army	447	807	694	1,080	854	812
Wpns. and Trkd. Combat Veh., Army	1,298	1,734	2,245	2,187	1,641	1,856
Ammunition, Army	276	391	351	448	317	419
Other, Army	1,630	1,937	2,214	2,135	1,955	2,487
Total, Army	**4,070**	**5,530**	**6,325**	**6,865**	**5,629**	**6,463**
Aircraft, Navy	1,875	2,687	2,888	3,424	3,254	3,238
Weapons, Navy	1,327	1,608	1,923	2,153	2,371	2,793
Shipbuilding, Navy	7,561	10,962	12,016	13,762	13,439	12,802
Other, Navy	1,246	1,593	1,989	2,482	2,432	2,384
Coastal Def Augmentation	-	-	-	-	184	-
Marine Corps	597	756	737	736	633	613
Total, Navy	**12,606**	**17,606**	**19,553**	**22,557**	**22,313**	**21,830**
Aircraft, Air Force	4,835	6,405	7,955	10,419	10,135	9,566
Missiles, Air Force	2,490	2,071	3,508	2,881	3,382	4,098
Other, Air Force	1,375	1,522	2,068	2,779	3,173	4,167
Total, Air Force	**8,700**	**9,998**	**13,531**	**16,079**	**16,690**	**17,831**
Defense Agencies	246	324	383	441	481	555
National Guard & Reserve Equipment, Defense		43	103	115	509	147
Defense Production Act Purchases	-	-	-	10	28	33
NATO Cooperative Defense	-	-	-	-	3	1
DoD Chemical Demilitarization	-	-	-	-	-	8
Total Unobligated Balances	**25,623**	**33,500**	**39,895**	**46,067**	**45,654**	**46,867**
Unobligated Balances: As a % of Availability	29.5%	30.7%	32.5%	33.4%	33.9%	32.5%

Chart 5

Concerns are often expressed that there are procurement funds lying around, from time immemorial, dormant. A review of this display of unobligated and unexpended balances in procurement, exclusive of shipbuilding, indicates that approximately 75 percent of them are no more than one year old, which relates back to the broad assumption mentioned earlier that roughly 75 percent of the funds do obligate in the first year.

Expenditures occur as progress is made or as end items are delivered. However, 85 percent of the unexpended balances are no more than two years old.

ANALYSIS OF PROCUREMENT (EXCLUDING SCN)
UNOBLIGATED AND UNEXPENDED BALANCES
($ BILLIONS)

	1982	1983	1984	1985	Est. 1986	Est 1987
UNOBLIGATED BALANCE	**18.1**	**22.5**	**27.9**	**32.3**	**32.2**	**34.1**
1st Year Balance	14.7	17.0	21.1	23.9	24.2	24.2
2nd Year Balance	3.3	5.5	6.8	8.4	8.0	9.9
UNEXPENDED BALANCE	**71.8**	**89.0**	**108.9**	**131.7**	**142.2**	**159.6**
1st Year Balance	47.5	54.4	63.5	72.5	66.2	73.9
2nd Year Balance	17.7	25.6	30.7	39.2	47.5	46.6
3rd Year Balance	3.8	5.9	10.7	13.4	18.1	25.6
4th Year Balance	1.4	1.3	2.3	4.0	6.0	8.5
Prior Years	1.5	1.8	1.7	2.6	4.4	5.0

Chart 6

There is nothing in this overview and aging analysis that indicates any great distortion relative to program execution.

Since the acquisition cycle is more extended for shipbuilding programs, it is informative to review an aging analysis for the SCN balances.

ANALYSIS OF SCN
UNOBLIGATED AND UNEXPENDED BALANCES
($ BILLIONS)

	1982	1983	1984	1985	Est. 1986	Est. 1987
UNOBLIGATED BALANCE	**7.6**	**11.0**	**12.0**	**13.8**	**13.4**	**12.8**
1st Year Balance	3.4	6.2	4.7	5.1	4.9	4.9
2nd Year Balance	1.9	2.2	4.8	3.4	3.1	2.9
3rd Year Balance	1.7	1.4	1.5	4.2	2.4	2.4
4th Year Balance	.6	1.2	1.0	1.1	3.1	2.6
UNEXPENDED BALANCE	**22.0**	**30.6**	**32.6**	**34.6**	**34.2**	**35.8**
1st Year Balance	8.1	15.1	10.9	11.1	9.3	[illegible]
2nd Year Balance	5.4	6.4	12.7	8.6	9.7	[illegible]
3rd Year Balance	4.4	3.9	4.4	10.0	6.3	7.5
4th Year Balance	1.7	2.9	2.6	2.7	7.4	4.1
Prior Years	2.4	2.3	2.0	2.2	1.5	5.4

Chart 7

Here the difference is dramatic. Unlike the other procurement accounts, SCN unobligated balances do not achieve 75 percent of availability until the second year or later. The longer the construction period, the longer the balances exist. As the program mix includes larger and/or more complex ships that require greater periods of time for program execution, the aging pattern will naturally reflect slower obligation and expenditure rates. The budget authority, however, must be made available by the Congress well in advance of contract award.

In order to more specifically illustrate this time-phased aspect of program execution, it might be interesting to review the contractual action for the F-16 aircraft program, the M1 tank program, and the DD 977 shipbuilding program.

Many separate contracts are involved in the execution of these programs. And, while the precise phasing for individual programs will vary, the Department is able to rely on aggregated historical data, in most instances, to make reasonably accurate budget projections.

AIRCRAFT EXECUTION
(Based on a Typical Program Year of the F-16 Program)
$ in millions

AIRCRAFT	INITIAL PROGRAM	ACTUAL OBLIGATIONS YR. 1	YR. 2	YR. 3
AIRFRAME	871.8	759.4	871.8	852.2*
RESERVES FOR ENGINEERING CHANGE ORDERS, ESCALATION, AND CONTINGENT LIABILITIES		(112.4)	(-0-)	(-0-)
ENGINE	409.8	383.7	406.1	409.8
RESERVES FOR ENGINEERING CHANGE ORDERS AND ESCALATION		(26.1)	(3.7)	(-0-)
GOVERNMENT FURNISHED EQUIPMENT	202.5	151.2	171.4	202.5
RESERVE FOR PHASED ITEMS, RADAR, ESCALATION, AND CONTINGENT LIABILITIES		(51.3)	(31.1)	(-0-)
SUPPORT	59.7	1.1	28.6	59.7
TRAINING/GROUND EQUIPMENT AND DATA		(58.6)	(31.1)	(-0-)
OTHER	13.9	12.1	13.9	13.9
RESERVES FOR CONSUMABLES UTILIZED IN ASSEMBLY/TEST		(1.8)	(-0-)	(-0-)
TOTAL PROGRAM	1,557.7			
TOTAL OBLIGATIONS		1,307.5	1,491.8	1,538.1*
UNOBLIGATED		(250.2)	(65.9)	(-0-)

	YR. 1	YR. 2	YR. 3	YR. 4	YR. 5
TOTAL OUTLAYS	171.2	943.6	1,363.9	1,487.1	1,528.3
YEAR TO YEAR OUTLAYS	171.2	772.4	420.3	123.2	41.2
UNEXPENDED	(1,386.5)	(614.1)	(174.2)	(51.0)	(9.8)

* Decrease Related to Negotiation Fall-out in 3rd Year

Chart 8

This chart illustrates the major contracts involved in a typical year's buy of F-16 aircraft. It summarizes how contracts would unfold for the procurement of about 96 F-16 aircraft.

In the first year, contracts would be awarded for the basic airframe, the engine, and for other government furnished equipment. At the end of the first year, for a program value of $1,557.7 million, over $1,307.5 million had been obligated, or approximately 84 percent.

The amounts in parentheses identify what remained unobligated at the end of that first year. The $250 million includes program manager reserves for engineering change orders, time-phased equipment not needed for immediate delivery in the first year, training and ground support equipment as well as technical publications required to support the aircraft upon delivery, and consumables required later in the production cycle for testing purposes.

By the end of the second year of program execution, 96 percent of the funds were obligated, with essentially 100 percent obligation by the end of the third year since the program value was decreased $19.6 million as a result of negotiations in the third year.

TANK EXECUTION
(Based on FY 1980 M1 Abrams Tank Program)
$ in Millions

M1 ABRAMS TANK	INITIAL PROGRAM	ACTUAL OBLIGATIONS YR.1	YR. 2	YR. 3
Vehicles	501	380	466	499
Contract Definitization		(89)	(3)	(-)
Initial Production Facilities		(30)	(30)	(-)
Contingent Liabilities		(2)	(2)	(2)
Government Furnished Equipment	26	14	21	24
Test Sets		(7)	(-)	(-)
Modifications		(3)	(3)	(-)
Contingent Liabilities		(2)	(2)	(2)
Support	53	52	52	52
Contingent Liabilities		(1)	(1)	(1)
Total Program	580			
Total Obligations		446	539	575
Unobligated		(134)	(41)	(5)

	YR. 1	YR. 2	YR. 3	YR. 4	YR. 5
TOTAL OUTLAYS	46	307	491	560	568
YEAR TO YEAR OUTLAYS	46	261	184	69	8
UNEXPENDED	(534)	(273)	(89)	(20)	(12)

Chart 9

This chart reflects the FY 1980 M1 Abrams tank program execution. The program procured 560 tanks. Obligations in the first year were around 77 percent. By the second year, they were 93 percent. Over 99 percent were obligated by the end of the third year.

SHIP EXECUTION
(Based on the DD 997 Program)
$ in Millions

SHIP	INITIAL PROGRAM	ACTUAL OBLIGATIONS YR. 1	YR. 2	YR. 3	YR. 4	YR. 5
SHIPYARD CONTRACT	269.0	58.4	231.0	234.3	251.3	253.9
DEFINITIZATION		(172.6)	(-)	(-)	(-)	(-)
CHANGES		(38.0)	(38.0)	(34.7)	(17.7)	(15.1)
GOVT. FURNISHED EQUIPMENT	51.7	3.4	25.0	27.5	34.7	45.0
SHORT LEAD TiME/ENG. SUP. FOR:						
ELECTRONICS EQUIPMENT		(7.4)	(2.0)	(1.3)	(.7)	(.6)
ORDNANCE EQUIPMENT		(37.2)	(21.2)	(19.4)	(13.3)	(4.8)
PROPULSION/HULL EQUIPMENT		(3.7)	(3.5)	(3.5)	(3.0)	(1.3)
OTHER	.7	-	.1	.1	.1	.7
ENGINEERING SUPPORT		(.7)	(.6)	(.6)	(.6)	(-)
TOTAL PROGRAM	321.4					
TOTAL OBLIGATIONS		61.8	256.1	261.9	286.1	299.6
UNOBLIGATED		(259.6)	(65.3)	(59.5)	(35.3)	(21.8)

	YR. 1	YR. 2	YR. 3	YR. 4	YR. 5	YR. 6	YR. 7
TOTAL OUTLAYS	21.8	92.4	159.2	213.6	259.1	277.0	296.7
YEAR TO YEAR OUTLAYS	21.8	70.6	66.8	54.4	45.5	17.9	19.7
UNEXPENDED	(299.6)	(229.0)	(162.2)	(107.8)	(62.3)	(44.4)	(24.7)

Chart 10

The procurement profile reflected for the DD 997 demonstrates the long construction period and slower obligation and outlay rates associated with shipbuilding programs. Approximately 16 percent of the program funds available were obligated in the first year. By the end of the second year, this had risen to 80 percent. The complexity of modern ships and the long construction period and spend-out rates are the driving factors behind the request that the Congress consider favorably a seven year availability for Shipbuilding appropriations.

The point is, for individual weapon systems, the phasing of the execution process will vary significantly among the individual appropriations. Projections of obligations and expenditures are developed by applying statistical projections of what is likely to happen. This information is complemented by judgments regarding the individual weapon systems and their contract and production phasing.

Our overall obligation and outlay estimates, then, are based on efforts to integrate both the anticipated characteristics of individual programs with relevant historical data.

DEPARTMENT OF DEFENSE BUDGET
FY 1982 - FY 1985 OBLIGATIONS AND OUTLAYS
($ Billions)

OBLIGATIONS	FY 82	FY 83	FY 84	FY 85
January Budget Plan	285.4	318.0	341.7	375.5
Actual	285.2	309.6	329.6	361.7
Actual as % of Plan	99.9%	97.6%	96.5%	96.3%
OUTLAYS	**FY 82**	**FY 83**	**FY 84**	**FY 85**
January Budget Plan	182.8	208.9	231.0	246.3
March/Apr Reestimate	-	-	-	-
May Revision	-	-	229.0	-
July Reestimate	-	208.9	227.0	241.0
Actual	182.8	205.0	220.8	244.1*
Actual as % of Plan				
Jan Budget Plan	100.0%	98.1%	95.6%	99.1%
March/Apr Reestimate	-	98.1%	-	-
May Revision	-	-	96.4%	-
July Reestimate	-	98.1%	97.3%	101.7%

* Excludes $1.3 billion for Navy Industrial Fund Federal Financing Bank direct loans.

Chart 11

This chart summarizes obligations and outlays by displaying what was projected for fiscal years 1982 through 1985 and what actually happened relative to the Department's estimates.

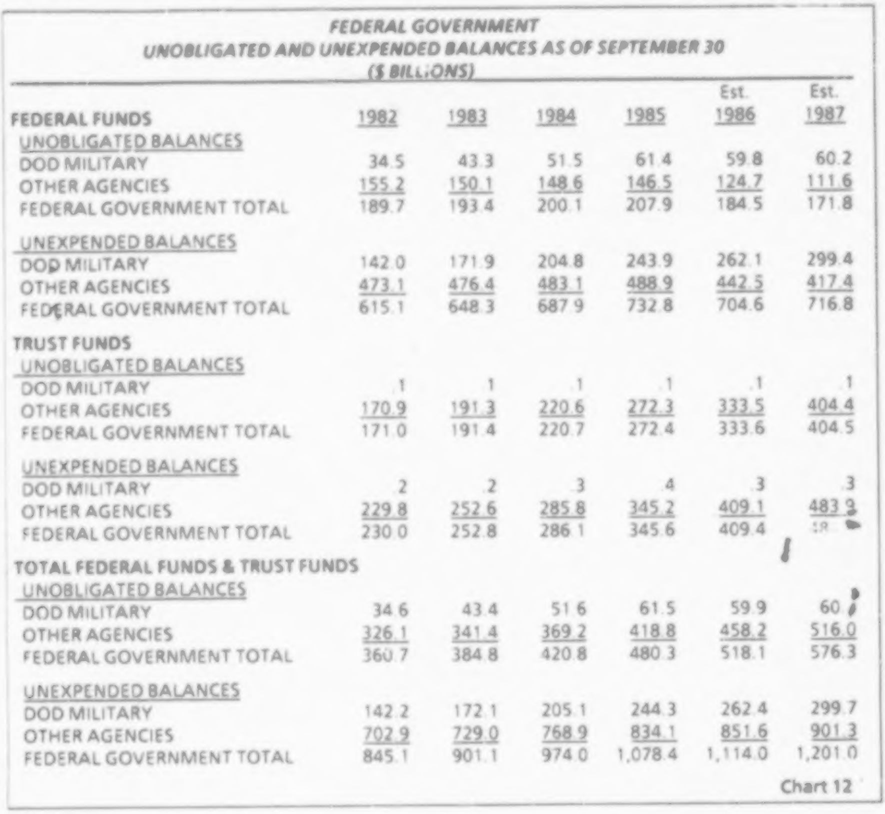
Projections of obligations each year include both the direct, or appropriated fund, program and the reimbursable, or customer, program. These projections reflect what the customer demand is estimated to be and the level of obligations against that estimate.

Outlay projections, on the other hand, depend both on historical data and management judgments and assumptions since disbursements are made at a large number of disbursing locations, and not through a single, central disbursing activity or the individual program manager organizations.

What is crucial to remember when reviewing summary tables such as this is that these statistics present only a composite. As such, they are only the starting point for further discussion and analysis. Even if the Department achieved 100 percent of its estimate in the macro-sense, it doesn't in any way lessen the need to look at individual programs. Even within a perfect overall projection, some individual programs experience delay while others may be ahead of schedule. Individual programs are reviewed to ensure that they have reached the point where they are prepared to enter production, that the estimates are good, and that production rates are adequate and achievable.

All of these factors determine the efficiency of program execution. And, good program management practices dictate that some of the available funds will be temporarily unobligated. Even the Congress, through implementation of the full funding policy, recognizes that, while all the funds required to fully execute a given program must be available before contracts may be entered into, execution will occur over a period of years; hence multi year appropriations. No good program manager will obligate funds prior to validating requirements and negotiating the best possible contract. Those familiar with the full funding policy of the Congress know that unobligated balances do not represent funds for which there is no requirement.

It is of interest to review a brief summary of the unobligated and unexpended balances for the Federal government as a whole. Balances are very large across the budget, not just for defense.



FEDERAL GOVERNMENT
UNOBLIGATED AND UNEXPENDED BALANCES AS OF SEPTEMBER 30
($ BILLIONS)

	1982	1983	1984	1985	Est. 1986	Est. 1987
FEDERAL FUNDS						
UNOBLIGATED BALANCES						
DOD MILITARY	34.5	43.3	51.5	61.4	59.8	60.2
OTHER AGENCIES	155.2	150.1	148.6	146.5	124.7	111.6
FEDERAL GOVERNMENT TOTAL	189.7	193.4	200.1	207.9	184.5	171.8
UNEXPENDED BALANCES						
DOD MILITARY	142.0	171.9	204.8	243.9	262.1	299.4
OTHER AGENCIES	473.1	476.4	483.1	488.9	442.5	417.4
FEDERAL GOVERNMENT TOTAL	615.1	648.3	687.9	732.8	704.6	716.8
TRUST FUNDS						
UNOBLIGATED BALANCES						
DOD MILITARY	.1	.1	.1	.1	.1	.1
OTHER AGENCIES	170.9	191.3	220.6	272.3	333.5	404.4
FEDERAL GOVERNMENT TOTAL	171.0	191.4	220.7	272.4	333.6	404.5
UNEXPENDED BALANCES						
DOD MILITARY	.2	.2	.3	.4	.3	.3
OTHER AGENCIES	229.8	252.6	285.8	345.2	409.1	483.9
FEDERAL GOVERNMENT TOTAL	230.0	252.8	286.1	345.6	409.4	[illegible]
TOTAL FEDERAL FUNDS & TRUST FUNDS						
UNOBLIGATED BALANCES						
DOD MILITARY	34.6	43.4	51.6	61.5	59.9	60.[illegible]
OTHER AGENCIES	326.1	341.4	369.2	418.8	458.2	516.0
FEDERAL GOVERNMENT TOTAL	360.7	384.8	420.8	480.3	518.1	576.3
UNEXPENDED BALANCES						
DOD MILITARY	142.2	172.1	205.1	244.3	262.4	299.7
OTHER AGENCIES	702.9	729.0	768.9	834.1	851.6	901.3
FEDERAL GOVERNMENT TOTAL	845.1	901.1	974.0	1,078.4	1,114.0	1,201.0

Chart 12

The point is that unobligated and unexpended balances are not excess funds but reflect prudent program and fiscal management. This is as true of other federal agencies as it is for the Department of Defense. The following tables presents the unobligated balances for all federal agencies.

FEDERAL GOVERNMENT
UNOBLIGATED BALANCES AS OF SEPTEMBER 30
($ BILLIONS)

	FY 1985	FY 1986 Est	FY 1987 Est
Legislative Branch	.4	.2	.2
Judiciary	.1	.1	.1
Executive Office of the President	*	*	*
Funds Appropriated to the President	31.2	29.7	29.6
Agriculture	2.2	1.4	2.1
Commerce	.4	.3	.3
Defense - Military	61.5	59.9	60.3
Defense - Civil 1/	10.7	23.9	39.5
Education	2.0	1.6	1.3
Energy	2,4	2.0	1.0
Health & Human Services (less Soc Sec)	36.6	48.5	59.2
Health & Human Services (Soc Sec) 2/	25.0	26.6	41.2
Housing and Urban Development 3/	58.5	56.2	49.2
Interior	2.0	1.7	1.6
Justice	.4	.3	.3
Labor 4/	19.8	24.2	29.4
State	3.0	3.1	3.5
Transportation	12.3	12.4	11.1
Treasury	23.8	16.0	16.2
Environmental Protection Agency	1.1	2.1	1.2
General Services Administration	1.2	1.4	.4
National Aeronautics & Space Administration	.9	.8	.6
Office of Personnel Management 5/	147.0	165.7	186.3
Small Business Administration	1.8	1.6	-
Veterans Administration	13.2	13.3	12.9
Other Independent Agencies	22.7	25.0	28.8
Total	**480.3**	**518.1**	**576.3**

1/ Includes Cemeterial Expenses, Army; Corps of Engineers; Military Retirement; Education Benefits; Soldiers' and Airmens' Home; Forest and Wildlife Conservation, Military Reservations.

2/ Includes Federal Old-Age and Survivors Insurance Trust Fund, Federal Disability Insurance Trust Fund, and associated Adminstrative Expenses.

3/ Balances largely result from Annual Contributions for Assisted Housing, including Rental Housing Assistance and Rent Supplement Programs.

4/ Balances primarily associated with the Unemployment Trust Fund.

5/ Balances primarily associated with the Civil Service Retirement and Disability Fund.

Chart 13

When one considers what happened in terms of inflation and program growth, conversion of these Federal balances to constant FY 1986 prices removes the effect of inflation and reflects the defense buildup.

FEDERAL GOVERNMENT
UNOBLIGATED AND UNEXPENDED BALANCES
($ BILLIONS)

	82	83	84	85	Est. 86	Est. 87
CURRENT PRICES						
UNOBLIGATED BALANCES						
DOD MILITARY	34.6	43.4	51.6	61.5	59.9	60.3
OTHER AGENCIES	326.1	341.4	369.2	418.8	458.2	516.0
FEDERAL GOVERNMENT TOTAL	360.7	384.8	420.8	480.3	518.1	576.3
UNEXPENDED BALANCES						
DOD MILITARY	142.2	172.1	205.1	244.3	262.4	299.7
OTHER AGENCIES	702.9	729.0	768.9	834.1	851.6	901.3
FEDERAL GOVERNMENT TOTAL	845.1	901.1	974.0	1,078.4	1,114.0	1,201.0
CONSTANT 1986 PRICES						
UNOBLIGATED BALANCES						
DOD MILITARY	40.3	49.1	56.8	65.6	61.9	60.3
OTHER AGENCIES	380.0	386.2	406.7	447.1	473.8	516.0
FEDERAL GOVERNMENT TOTAL	420.3	435.3	463.5	512.7	535.7	576.3
UNEXPENDED BALANCES						
DOD MILITARY	165.7	194.6	225.9	260.7	271.3	299.7
OTHER AGENCIES	819.1	824.8	847.0	890.4	880.7	901.3
FEDERAL GOVERNMENT TOTAL	984.8	1,019.4	1,072.9	1,151.1	1,152.0	1,201.0

Chart 14

Again, it is important to recognize the phenomenon of large numbers. As a result of program growth and changes in program mix from year to year, the balances must be expected to grow.

It is important to remember, however, that the numbers were always big. They were big decades ago, relatively speaking. Still, there was concern about their existence then as there is now.

To conclude the discussion of unobligated and unexpended balances, one should not presume a negative connotation to the existence of unobligated and unexpended balances. The notion must be dispelled that these balances are comparable to non-interest bearing cash in an individual's checking account.

Unexpended but obligated balances can only be reduced by the cancellation of existing contracts or increased performance on the part of industry. Unobligated balances can be reduced by cancellation of programs previously approved by the Congress, by abandoning the congressional principle of "full funding" capital investments, or by acceleration of contract awards by the Department of Defense.

Those who would abandon the full funding policy in an attempt to reduce these balances should realize that considerable complications would be added to the annual budget cycle. In addition, the abandonment of the full funding principle would eliminate the ability of the Department to determine full liability of the Federal Government for defense programs.

Unobligated and unexpended balances provide a useful measure of Federal Government commitments. They do not signify inefficiencies in the fiscal policies of various Government agencies.

An associated topic is the matter of lapsed budget authority.

Lapsing Balances

Lapsing balances are those appropriations remaining unobligated when the period of obligational availability expires, but still remaining available for obligation adjustments and disbursement under certain circumstances. Such circumstances might arise from future liabilities of contracts that had not been totally completed when the appropriation account expired. For example, lapsed funds may be restored to cover upward adjustments of prices, claims or adjudicated change orders on contracts which were awarded during the period of availability.

SUMMARY OF DOD LAPSING BALANCES
($ in millions)

	FY 1982	FY 1983	FY 1984	FY 1985
Military Personnel	46	50	186	183
Retired Pay	46	201	18	-
Operation & Maintenance	302	338	540	498
Procurement	1,186	1,371	2,388	923
(Reappropriations)	(250)	(423)	(939)	(70)
RDT&E	67	115	98	95
(Reappropriations)	(32)	(60)	(27)	(20)
Military Construction	-	92	17	19
(Reappropriations)	-			
Family Housing	12	43	26	54
(Reappropriations)	(2)	-	-	-
Special Foreign Currency	1	3	2	-
Total	1,660	2,213	3,275	1,773
(Reappropriations)	(284)	(483)	(966)	(90)
Accounting Lapse	1,376	1,730	2,309	1,683

Chart 15

Reflected in the FY 1985 column of the FY 1987 budget request are financing entries of $1.8 billion denoting lapsing balances.

Included in these amounts, by OMB direction, are $90 million in funds that were reappropriated by the Congress, an entry that should not be categorized in the same manner as lapsing authority. The true accounting lapse can be determined only after subtracting the amount reappropriated from the amounts displayed in budget exhibits. Therefore, the FY 1985 accounting lapse was $1.7 billion compared to an FY 1984 amount of $2.3 billion.

Further, included within the $1.7 billion in lapses reported to the Treasury in FY 1985 was $.6 billion which, in accordance with the FY 1985 DoD Appropriations Act, is still available for obligations associated with the completion of programmed work in progress for shipbuilding and ship overhauls. These funds technically have to lapse and are reported to the Treasury because there is no legal language provision extending the period of availability. A similar provision addressing overhauls was included in the FY 1983 and FY 1984 Appropriations Acts.

The FY 1985 lapse after these adjustments was $1.1 billion or .6 percent of authority appropriated, compared to $1.4 billion in FY 1984. The total lapsing represents the composite of literally hundreds of thousands of contractual actions on the multitude of defense programs. This includes amounts necessary to cover the legal requirement to reserve sufficient authority for adjustments to contracts entered into prior to expiration of the account. This contingency reserve is primarily in the investment accounts.

This balance should be improved upon through the management initiatives currently being implemented within the Department, as the FY 1985 data prove. However, as long as the Anti-Deficiency Act contains penalties of imprisonment and/or fines for violations, contingency reserve estimates will continue to be conservative. The Department consistently strives to execute its programs as approved and intended by the Congress. There will always be lapses of some amount. We strive to limit them to amounts which represent prudent management or legal requirements rather than the result of waste or inefficiencies

The next important phase of execution is the reprograming of appropriated funds. There are occasions when funds are required for uses other than those approved by the Congress or to comply with Committee report language. Reprograming actions provide with the flexibility to respond to these requirements as they occur rather than waiting until the next annual budget cycle.

Reprograming

There are circumstances which alter even the best of budget estimates. The economy may vary in terms of inflation; political realities may bring external forces to bear; fact-of-life or programmatic changes may occur. The very nature of the lengthy and overlapping cycles of the budget process poses continual threats to the integrity of budget estimates.

Reprograming procedures permit the Department of Defense to respond to these unforeseen changes and still meet defense requirements.

Reprograming and transfer authority have been granted to the Department by the Congress under a set of procedures and guidelines that permit the Department to have flexibility in the management of its programs, while, at the same time, recognizing the oversight responsibilities of the Congress.

These procedures have evolved through many years of effort by members of defense oversight committees of the Congress and various officials in the Department of Defense. Although reprograming has worked to aid both DoD and the Congress in overseeing defense programs, these procedures require continuous understanding, support and agreement of all parties.

Reprograming is the utilization of funds for purposes other than those contemplated at the time of appropriation enactment. Reprograming actions do not represent requests for additional funds from the Congress, rather, the reapplication of resources already available to the Department.

A reprograming action can involve a transfer between appropriation accounts or the reapplication of funds within an account. A reprograming action can even involve an increase of weapons quantities without necessarily entailing any increase of funds.

A transfer may involve reapplication of funds; between appropriation accounts, between legal subdivisions within an account, or between budget activities of the same appropriation account. Accounts which currently contain legal subdivisions are: Missile Procurement, Army; Weapons Procurement, Navy; Other Procurement, Navy; and Shipbuilding and Conversion, Navy.

The reprograming process begins only after enactment of authorizations and appropriations which, of course, express the will of the Congress in terms of the defense program. Upon completion of the authorization and appropriation process, the Department develops the base for future reprogramings by defining in line item detail the intent of the Congress in enacting lump sum appropriations. This detail is based upon the budget programs requested, plus or minus congressional changes. In turn, the committee approval of reprograming actions requested by the Department against this baseline serves to ensure that funds approved by the Congress for one purpose are used for another only with the expressed consent of the Congress. A status report is provided twice a year as the Department reports, in detail, actions approved by the committees.

Prior Approval/Notification Reprogramings

The following charts summarize the criteria, agreed to by the congressional committees that are used to determine the requirement for congressional notification or approval of proposed DoD reprograming actions.

REPROGRAMING GUIDELINES REQUIRING PRIOR COMMITTEE APPROVAL

- Action to increase the procurement quantity of a specific:
  - Aircraft and related support equipment
  - Missile and related support equipment
  - Naval vessel and related support equipment
  - Torpedo and related support equipment
- Action requiring the use of general transfer authority.
- Action involving the application of funds which is known to be or has been designated a matter of special interest to one or more of the congressional committees.

Chart 16

If a reprograming action increases the authorized procurement quantity of a particular program, moves funds between appropriation accounts, or adjusts funding in a program designated as of special interest to the Congress, then prior approval is required.

REPROGRAMING GUIDELINES REQUIRING NOTIFICATION TO THE COMMITTEES

• Military Personnel	- Increase of $10 million or more per budget activity
• Operation & Maintenance	- Increase of $5 million or more per budget activity
• Procurement	- Increase of $10 million or more per existing line item - Addition of a line item of $2 million or more
• RDT&E	- Increase of $4 million or more per existing program element - Addition of a new program of $2 million or more - Addition of a new program estimated to cost $10 million or more within a 3-year period

- Reprograming actions initiating new programs or line items which result in significant follow-on costs require notification, even though initial actions are below these thresholds.

Chart 17

Congressional notification is required for those reprogramings that exceed established thresholds for the various appropriation accounts. These guidelines provide the Department with much needed flexibility in the management of programs and efficient use of resources.

The reprograming arrangements the Department has with its oversight committees are very valuable. They provide the Department essential flexibility in meeting program execution requirements which may be quite different from those requirements against which we originally budgeted. They also provide retention of congressional control over the utilization of defense resources.

This chart provides the dollar value of reprogramings submitted to congressional committees over the last few fiscal years:

DOD REPROGRAMINGS SUBMITTED TO THE CONGRESS, FY 1983-85
(Millions of Dollars)

	FY 1982	FY 1983	FY 1984	FY 1985
DoD Bill	1,681	2,528	1,644	2,560
MilCon Bill	359	409	498	604
Total	2,040	2,937	2,142	3,164

Chart 18

A Shipbuilding and Conversion, Navy reprograming in FY 1984 approved a transfer of funds to the battleship reactivation advance procurement program to accelerate the delivery of the USS Missouri to April 1986 instead of July 1986. Were it not for the use of reprograming procedures, the President would have to turn to supplemental appropriation requests as a means to seek such use of funds. This could be far more time consuming, could only occur as part of the regular congressional cycle, and therefore would be much less effective in meeting emergency requirements.

A review of reprogramings in FY 1985 demonstrates the flexibility afforded DoD and the Congress. In response to congressional direction, the Department reprogramed FY 1984 basic submarine construction contract savings to fund the advance procurement requirements of the SSN-688 Class submarine. Also in response to congressional direction, funds appropriated for the HARM missile program were diverted to the development of a low cost seeker (LCS).

Such flexibility provides the Department with the ability to respond to unforeseen circumstances, events that occur once a fiscal year is underway and appropriations already established. An example of an unforeseen event was the unexpected fire at Tinker Air Force Base.

Reprograming actions have played an important role in the operations of the Department of Defense. Historically, reprograming authority has permitted the Department to accommodate unanticipated requirements, changes in operating conditions, and revisions in price estimates in a businesslike and economical manner. Unfortunately, the Department no longer has the authority to transfer prior year appropriations forward to fund current requirements, an unfortunate loss since such authority greatly facilitates the identification of savings. And, while the Department of Defense has been urged to reduce the level of reprograming activity initiated by the Department, the Congress has markedly increased the number of directed reprogramings to fund congressionally approved, but unfunded, programs.

Reprograming authority, used discreetly, is an invaluable tool to effective management of defense resources. It is the Department's full intention to retain a disciplined reprograming process that reflects the intention of the Congress, the dynamic requirements of the Department, and the integrity of the approval process.

Chairman DOMENICI. Now, Senator Gorton.

Senator GORTON. Mr. Secretary, this is your sixth annual appearance before this committee, eloquently stating with illustrations, the urgency with which you see the problems of national security and national defense in the United States. You do an outstanding job in presenting those concerns. You also, from that experience, recognize that there is substantial disagreement with major portions of your presentation or your requests on the part of Members of Congress.

And that resistance or that disagreement has been increasing and some of it has been expressed here today, that, in fact, you will not get the request that you make for fiscal year 1987. And that, in fact, if there is no settlement, no resolution among the various conflicting points of view on budget priorities this year, that you are faced with what I know you regard with deep concern, an entirely different set of circumstances or consequences to the failure for Congress and the President to come to some kind of an accommodation. And if there is no agreement and Gramm-Rudman-Hollings goes into effect, through a set of automatic reductions, on October 1, I am certain that you would describe its effect on the national defense as being devastating.

On the assumption that you have a choice, only between that Gramm-Rudman-Hollings result and strongly recommending to the President of the United States that he enter into an accommodation with Members of Congress, who feel that meeting Gramm-Rudman-Hollings must be more balanced and must include a measurable component of new revenue and that without that, you cannot get out of the Congress, what you consider to be national defense necessities, what will your recommendation to the President be?

PRESIDENT TINGED WITH SKEPTICISM

Secretary WEINBERGER. Well, Senator, it would be colored a bit by history and history is that in 1982, the President agreed with various people in the Congress that if he agreed to a tax increase that year, he would have $1 of tax increase and for each dollar of that, he would get $3 reductions in expenditure.

The President feels that he did not get that. The reason that he feels that is, because he did not get it. The next year, he made an ageement in the Rose Garden, as it was so-called for the defense level of expenditure and he did not get that.

The next year, he made an agreement for zero, 3 percent, 3 percent real growth in defense funding levels and it was stated in the congressional budget resolution of August and he did not get that. Instead of zero, he got minus 6. So I think that the President is tinged with some skepticism about agreements and one of the problems, of course, is, to be perfectly blunt about it, there is nobody with whom the President can make an agreement who can deliver, because that has been the history of the past few years.

We would like very much to avoid all confrontations and to be able to persuade the people and the Congress of the amounts that we feel are necessary for all of these agencies. The President's budget states the very best position that he believes that we can have, given the financial situation, a budget that meets the Gramm-Rudman-Hollings target and does not require a tax increase, protects Social Security and has an adequate increase in defense—all of these things are before you and since it has been before you all of one day, it does seem to me a little bit early to start talking about ccmpromising it, right away, particularly when compromises of the past 3 years have simply not been kept.

Senator GORTON. In other words, Mr. Secretary, you are not going to answer my question?

Secretary WEINBERGER. Well, I have answered your question, Senator, but you asked me if I would urge the President to enter into an agreement to get the agreed amount for defense——

REVENUE INCREASE NOT RECOMMENDED

Senator GORTON. I gave you a hypothetical. I asked if you were faced with a confrontation here, the net result of which would be the application of Gramm-Rudman-Hollings' automatic cuts for defense for fiscal year 1987, that was your only other alternative, would you recommend a revenue increase to do better for national defense to the President?

Secretary WEINBERGER. No; I would not recommend a revenue increase, Senator, and I am breaking a rule here, because I always tell the press that I never answer hypothetical questions, but since you have asked it, I will respond. I would not recommend a revenue increase because the tax cut that the President initiated, and the Congress approved, has given us a 42-percent increase in revenues since it went into effect.

But during the same period that we got a 42-percent increase in revenues, we had a 61-percent increase in expenditures.

And the President feels, I think, that if you increase taxes, you invite more expenditures, probably not for the priorities that he has in mind and that we think are essential, but probably for more of the things that have given us the problems and the deficits that we have now.

And I have to tell you frankly, that I do not think that a tax increase is the way to solve the problems that we have now. I do not think that there is the slightest suggestion that a tax increase would bring additional revenue for the security requirements of the nation and I do think that a tax increase would harm the economy as opposed to giving it the bouyancy that the tax cut did.

Senator GORTON. Mr. Chairman, it took me an awful long time to get an answer to one question, may I ask one more on a different subject?

Chairman DOMENICI. Proceed.

STEALTH TECHNOLOGY NOT FOR OPEN DISCUSSION

Senator GORTON. Mr. Secretary, the Department of Defense budget includes an unknown but I presume large amount of funding for the development of Stealth technology. In your testimony, you say that work on the system is progressing smoothly and that you say that the technology is designed to take advantage of, or that it represents a major advance of extraordinary military significance.

Given the potential of this technology for our defense in the future and hence for defense spending for strategic resources, is it not time now for the Department of Defense to make more information available to this committee and to other relevant committees about our success with the program?

How much longer are we simply going to continue it as simply a part of the black budget?

Secretary WEINBERGER. Well, I will give you a very short answer to that, Senator, the answer is no. It is not time in my opinion because it is not a matter of informing the committee, it is a matter of informing the Soviets. We have made a great deal of information available in closed hearings and to the appropriate committees and we are perfectly prepared to do that. But I am certainly not prepared to discuss the Stealth program any further than we have done in the presentation, simply for the reason that we do not think that the Soviets have any need or right to know.

Senator GORTON. Thank you very much.

Chairman DOMENICI. Senator Hart.

Senator HART. Mr. Secretary, yesterday, before the Senate Armed Services Committee, you said, as I recall, that defense was one of the most important, and I think, in fact, you said that it was the most important function of Government.

I have a personal curiosity that you may be able to satisfy for me. The past 5 years, the President of the United States has criticized the Congress, particularly, or urged Congress to make cuts in Government spending. And I just wanted to know if you knew why your agency, the largest in the Federal Government that spends about one-third of all of our dollars, the President does not believe that is Government spending and does not include in Government spending.

Is that kind of a personal idiosyncracy or is there a possibility that he genuinely does not believe that that is Government spending?

NO QUESTION WHAT IS GOVERNMENT SPENDING

Secretary **Weinberger**. Oh, I am sure that he thinks that it is Government spending, Senator. I think that he knows it better than any of us. I think that he feels that it is, as I tried to say yesterday—I did not say it the way that you said it—I said that it is a function that can only be performed by the Federal Government, not by anybody else. And therefore, it is a matter, obviously, of extraordinary importance, because on its successful completion depends the enactment and carrying out of all of the other programs of the Nation. But it certainly is Government spending. There is not the slightest question about that in the President's mind or in my mind. I think that it is efficient and effective and vitally needed spending.

Senator **Hart**. Why does he not include it when he talks about cutting government spending? That was my question.

Secretary **Weinberger**. Well, because he feels that when it was cut 20 percent in real terms in the decade of the 1970's, it put us very dangerously behind. He went through the Nation in 1980 making that point and he was asked repeatedly about balanced budgets and he said, if it ever came to a question of the difference between balancing a budget and providing adequately for the security of the nation, he would always choose the latter and his views were not rejected by the people.

Senator **Hart**. So, he really does not mean cut Government spending, he means cut some Government spending.

Secretary **Weinberger**. He means cut some Government spending. He certainly means cutting wherever you can, but after you have had a decline of 20 percent for a decade, when your principal adversary, the Soviet Union, is going up 50 percent, obviously, he means that some spending has to be done, particularly, when no one else but the Federal Government can do it.

Senator **Hart**. Admiral Crowe, are there any nonbudgetary areas in military strategy or tactics or doctrine that concern you?

We have spent all of our time today, and spend virtually all of our time on the defense issue, discussing how much we are spending—whether we are spending too much or too little, and not on how we are spending it.

As I recall from our meeting years ago, you are a student of military history and I am glad of that. You know there have been nations throughout history that have outspent their foes, their opponents and lost. You know also there is no necessary, historic connection between how much money you spend and whether you win or lose. Are you satisfied, for example, that the Secretary of the Navy's strategy of forward deploying our large carriers in the Baltic Sea waters, the waters of the Scandinavian countries very near the Soviet homeland is a sound doctrine?

Is forward defense in Europe and accommodation to German political realities a sound doctrine?

Or, for that matter, that the Marine Corps' resistance to maneuver warfare and, in some cases, the Army's resistance to maneuver warfare, is the way that we ought to be going?

Do areas like that concern you—areas that are not budgetary in nature?

AREAS OF NONBUDGETARY CONCERN

Admiral **Crowe**. Senator, to answer the question, first of all, in a simplistic fashion, of course there are. I do not know that any commander in our services, and certainly in my experience, if you go over his spectrum of problems, would not say, I have some concerns here, aside from spending money and buying equipment and so forth. The kinds of things that commanders worry about traditionally, and they are just as applicable today as they have ever been, are number one, are we training realistically? Are our exercises adjusting to advancements, et cetera, et cetera?

No. 2, are we thinking smart in our tactics?

And that is what you are essentially referring to. To be frank about it, if I could for just a moment, these are the kinds of things that face American commanders and have now for 40 years, since World War II.

I hear a great deal, and in the last 2 days I have heard a great deal about fiscal reality and political reality and so forth. Well, I would like just for a moment to comment on military reality. The military reality in my experience has been that American commanders are always looking at a threat that is much larger than they are. Now, as long as I can remember, having been in the Navy, and now, in the U.S. Armed Forces, the charts that the Secretary showed here are not just a snapshot this year; in fact, the ratios have been worse, before, in my experience.

That is one of the reasons that the American commanders are so encouraged by some of what has been done in the last few years. For the first time, we have seen some of our sustainability shortages which we got used to living with, beginning to erode, we have seen our training improve in quantum jumps, we have seen some modern equipment come in and we have seen what we believe is the gap begin to close.

But there is no American commander suggesting that we match the Soviets weapon for weapon, gun for gun, or ship for ship. What he is going to have to do, though, since he does not advocate that, is fight smarter. Because he is facing these ratios and so forth, he is very worried about even a modest decrease in the budget.

Senator **Hart**. But Admiral, that gets exactly to my question. Are we preparing to fight smarter or are we simply trying to catch-up?

SOVIET'S VULNERABILITIES EXPLOITED

Admiral **Crowe**. No, we are trying very hard, Senator. Now, I am not going to tell you that we have solved all of our problems or that we do everything the best way that we can but just within the last 5 years, I have seen a completely new view of how we would have a theater strategy for each theater. And how we would try to exploit the vulnerabilities of the Soviets. And how we would concentrate sequentially rather than simultaneously. In my theater in the Pacific, because we cannot match the Soviets weapon for weapon, because we do not have the resources or the assets to go all over the Pacific theater, we had to decide what parts of the Pacific theater we could fight in and concentrate enough forces to bring leverage on them that we would win.

We revised our strategy and now that is what you are talking about. Secretary Lehman's thinking and the maritime concept and the way that he is looking at it, is an example of an effort to come to a strategy that plays on our strengths and exploits their vulnerabilities. As to whether we were actually going to deploy in the Norwegian Sea, that is a rather simple question that has to do with a very complicated scenario—what is the situation, what is the threat that we are facing at the time, and et cetera, et cetera?

It certainly is possible that we will do that. I think that we will fight offensively, we have changed our mind about that.

MANEUVER WARFARE NOT CHEAP

I would like to comment on what you said about maneuver warfare. In my view, there is an awful lot of mythology written on maneuver warfare. I think that both our Army and our Marine Corps do plan to use maneuver warfare to a certain extent, and anybody that is going to win, is going to have to use it when appropriate. Many people, though, are using that argument to say that it is a cheaper way for defense.

Senator **Hart**. No one I know is arguing that.

Admiral **Crowe**. Well, some advocates do, Senator, and I hear it all the time. Maneuver warfare is an excellent device for winning battles in certain situations but in protracted conflict, you cannot use maneuver warfare all the time. You have to be prepared to slug it out and when an opportunity opens for you, you use maneuver warfare to take advantage of it, but it is not cheaper, and it does not save you men. It may win wars, but it does not save you like some people think.

And we are taking advantage of that, our doctrine is changing.

Senator **Hart**. Well, Admiral, I hope that you understand that there are an increasing number of Members of Congress who have, if they have not given up on this budget hassle that goes on every year, increasing concerns about issues of this sort.

Admiral **Crowe**. And I welcome that, very much. I am seeing a lot more curiosity about the nitty gritty of defense and we do not object to that all. We welcome that.

Chairman **Domenici**. Thank you, Senator.

Senator Quayle.

Senator **Quayle**. Thank you, Mr. Chairman, and welcome gentlemen.

Admiral Crowe, I was listening to your statement, that we are losing a little bit of the qualitative edge vis-a-vis the Soviet Union. Could you explain what you meant by that?

Admiral **Crowe**. I am not sure of the statement that you refer to, Senator?

QUALITATIVE GAP NARROWING

Senator **Quayle**. In your opening statement you said, the gap was narrowing on the qualitative edge of the United States versus the Soviet Union.

Admiral **Crowe**. Well, I think that——

Senator **Quayle**. I know that you said, qualitative not quantitative, that is what struck me.

Admiral CROWE. I may have misled you, Senator. What I meant to say was that I think, in the past few years, due to all of the improvements in our ways of hoping to fight smarter, that we are narrowing the gap.

Senator QUAYLE. When you talk about a gap, are you talking about qualitative, quantative or both?

Admiral CROWE. I am talking both, Senator.

Senator QUAYLE. That we are narrowing——

Admiral CROWE. And when I say qualitative, you may be just referring to a specific weapon system but I am talking about our ability to——

Senator QUAYLE. OK, perhaps I was struck when I was listening to your statement for I thought that you said, the qualitative edge of the gap——

Admiral CROWE. It may have been a mischoice of words.

Senator QUAYLE. was somewhat under the impression that on a qualitative basis we——

Admiral CROWE. I was using the word qualitative to refer to how we use our systems and how we deploy and how we fight.

Senator QUAYLE. Not necessarily the qualitativeness of the individual weapons system.

Admiral CROWE. Not necessarily. We are not losing that and we hope that they are not closing the gap, because we have enjoyed some technological advantages, in electronics——

Senator QUAYLE. Well, that is what you said, and it is what I would like to focus on. How are the Soviets closing the gap on this qualitative advantage that we, in the past, have had?

Admiral CROWE. Well, it is not so much that there is a gap, there are things that they did not use to be able to do in electronics, in radar, in submarines. For example, in their submarines. We have, for years, enjoyed a tremendous advantage in submarines in noise reduction, etc., etc. The Soviets know that and they now, after a certain period of time, decided to invest in research and they are becoming better at submarining, and they are becoming better at quieting their submarines.

We have to run very hard if we are going to retain a qualitative edge in that area and this is true of many things.

MORE MUST BE DONE TO RETAIN QUALITATIVE EDGE

Senator QUAYLE. So, basically, what you are saying is that to retain our qualitative edge, that we have had in the past, we are going to have to do much more?

Admiral CROWE. Precisely.

Senator QUAYLE. Because of what the Soviets have been able to achieve in qualitative and technological advancements, they currently are much better than what they have been in the past. In the past, I believe that it has been conceded that we did have certain qualitative advantages.

Admiral Crowe, what you said is the point that I am trying to get at, and that is, that the gap that we have had in the past has narrowed, meaning that the threat is more imminent today than it has been in the past. Therefore, our investment in the defense expenditures, particularly, the new programs and the modernization of existing programs is more important today than it has been in the past.

That is certainly what I got out of your statement.

Admiral CROWE. That is correct, Senator. I was confused about what you were talking about, but through investment and through effort and through stealing our technology, they have made some very rapid advances in technology.

CONGRESSIONALLY IMPOSED WASTE AND INEFFICIENCY

Senator QUAYLE. We have heard a lot of discussion today about the historic analysis, Mr. Secretary, and everyone has their own set of statistics.

Perhaps the fairest way is to just to see what percent of the GNP our Nation is spending on defense, as a matter of priorities?

If we look at the percentages of our GNP allotted defense in the past, particularly from the late 1950's to before Vietnam, we see it was considerably higher, 8 to 10 percent of GNP. Today, however, even with the restoration of the investment in defense spending, we are still at only 6 percent of GNP.

So, I would dare say, that as a priority basis, looking at the resources we allocate for defense spending, that we are certainly not over-spending in the area of defense.

Also, Mr. Secretary, I wonder if you might be able to furnish this committee a list of the items that Congress imposes on the defense budget, whether it would be weapons systems, things of that sort, that the Defense Department did not ask for?

I think that we will find that there are a lot of items that go through Congress that are added to the defense budget. Based upon your assessment and items the military recommends not necessary, would you identify what I would call the congressionally imposed waste or inefficiency in the defense budget.

And I think it would be very helpful for this committee to try to examine where some of these problems are, if we could have that list.[1]

Secretary WEINBERGER. There is a lot of it, and we would be glad to do that, Senator.

Chairman DOMENICI. I might say that we have already asked that of the Secretary before you arrived, but not singularly, but rather as a part of a report with reference to the disparities between the original request of the President and the ultimate votes here.

Senator QUAYLE. Finally, Mr. Chairman, I think as we proceed in this debate, I do not think that it would be appropriate for the Secretary to get into the defense budget in detail today, because we still have the President's entire budget to cover, which in many respects, I support and which we must discuss. Yesterday, before the Senate Armed Services Committee, and here, before the Budget Committee, from your testimony and congressional tenor it appears that there are going to be some reductions, and some people even think dramatic, radical reductions.

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[1] See Congressional Adjustments to DOD Budget Requests, p. 223.

FORCE STRUCTURE CUTS WOULD BE DAMAGING

I certainly hope that we do not get back to the negative 6 percent we experienced this year. I think that would be just absolutely disasterous; however, I think that at some time during this debate, Mr. Secretary, that we are just going to have to ante up as to what we really mean when we talk about another zero growth in defense or maybe even an inflation growth. I imagine that if we take another big lick out of defense, like we have in the past, we are talking about force structure changes and about reductions in personnel, particularly on the civilian side. We are talking about layoffs not just changing one's hours or freezing their wages, we are talking about layoffs. You are also talking about potential contract termination, so I encourage you to take a very close look at this. It may affect my State, and it may affect Chairman Domenici's State, it may affect Senator Hollings and Senator Exon, all of whom support defense spending, because last year, Congress gave additional authorization for potential base closings.

I know that this is a political hot potato but if we are going to sit here and cut defense, by golly, we had better start looking at some of these base closings. When it comes home to roost, wherever it may fall, we are going to make that decision, and we are going to get into some very serious situations. I think that as time goes on, we need to know that information.

I can only say, as one who is beginning to look closely at this and some of the discussions which I have heard these last 2 days, that after we finish the first round of discussions, we are going to have to listen to some of these people who are just all of a sudden throwing numbers out there, zero real growth, or freeze, or minus 3, not knowing exactly what it means. You know what it means and I have an idea what it means. I believe that what I have just pronounced is pretty much on target what this means, if we in fact, go that route.

Secretary **Weinberger**. The force structure cuts would be the first and most visible thing and they would be terribly damaging. That is why we hope that this trigger will never actually be pulled. On the base closings, we have talked with Senator Goldwater about that many times. We need legislation that enables it to be done quickly and we need to do some funding for the initial year's expenditures, after which you start to get some savings. And, of course we have lists and are fully prepared to cooperate with the Congress in that.

But legislation to make the base closings, to be able to do it far more quickly, than the 22 or 24 months that is required now, is an essential part of it.

But I agree with everything that you have said Senator.

Chairman **Domenici**. Senator Hollings.

Senator **Hollings**. Thank you, Mr. Chairman.

DEFENSE HAS GROWN 7 PERCENT

Mr. Secretary, I most respectfully respect you and know of your brilliance and dedication. But you have made yourself an easy target and I hate to have to say that because you and I both want to help defense. Now the truth is that we have had a 7-percent real growth on average in defense in this decade, right straight across the board. Billions have gone to Defense, an investment we have supported I might, as an aside, say that I am the one who 10 years ago drew up that 5-percent real growth under President Carter. And more recently here, in December before Christmas I opposed the Bradley amendment's 5-percent cut in national defense.

Now, the Presidential Packard Commission, and two of the best minds in the military, Senator Goldwater and Senator Nunn, are telling us about procurement difficulties. They say the military is overstaffed and overloaded in reorganization.

You have become a target and I can only suggest that you understand exactly why. You cannot come up with straw men and knock them down and use these percentage figures, and Rose Garden numbers and the like. Those were not commitments. I was up here at the Budget Committee and the day that I heard about it and read it in the paper, why I will show you records, but what happened, I think, as the co-sponsor of Gramm-Rudman-Hollings, I will tell you exactly what happened, from last August. You are looking at the enemy and what has happened to our defense, and what have the Soviets done?

We have stopped playing the game. The game as it was described by President Reagan, to me and others, was this: Reagan said, "Speaker O'Neill came on over and we had a little toddy and we went out over there, under the Oak tree." The Speaker said, "I will take your defense Mr. President if you take my Social Security." And the President said, "Yes, fine, and we won't raise taxes to pay for either. There will not be any revenue." Tip said, "That is fine with me. I am against taxes."

Now that game, that charade, has ended, period. We have been playing it for 5 years and it is Rome with bread and circuses. Well, we have been delivering them a dollar's worth of government for only 75 cents. We have been reelected by raiding the fruits of the next generation.

So let us all get on top of the table here and quit that game and understand that we are going to have to pay for these things. That is exactly what I want to emphasize. I am for raising revenues. I beat the Bradley amendment by stating that I was for it and made the recommendations for the revenues and will with the chairman here, later on perhaps this month.

DECLINE IN OIL PRICE FACTORED IN

Along the line of your request, did you factor in the drop now in your request from $28 a barrel of oil, to $16 a barrel of oil? I was around here when Senator Muskie and Senator Domenici—you remember back in 1979 and 1980 we had to up it $2 billion after we had figured it to buy fuel.

Now, do we get a little bit of leverage there?

Secretary **WEINBERGER**. We do, sir, yes, and we have factored it in and as with all of these inflation estimates of what will be the cost of oil in 17, 22, 24 months, we do have to try our best estimate on it. We never get a price which is the lowest price such as $16 a barrel or $19 a barrel, we have to get special kinds of oil and they go through dealers and all the rest, but we have factored in a decline in the oil price, yes, sir, we have.

And if we are wrong, if we have not done enough, then that will show up as an inflation savings and we will turn it back to the Treasury or we will ask you if it could be reprogrammed so that we would not have to appropriate as much in the subsequent year. That is the pattern of inflation estimates that run below, when they run over, it is exactly as you say, you have to have a supplemental.

REENLISTMENTS ARE DROPPING

Senator HOLLINGS. Admiral Crowe, with respect to the demographics, I would like to point out that studies show that the military needs one out of every five of the available manpower pool between 17 and 22, by 1991.

Your reenlistments, as you have stated, are dropping. This of course has been of a current interest with me, because I think that it is improper not to call on all Americans. I am not arguing the effectiveness of the volunteer Army; I am merely questioning the fairness and adequacy of it as far as recruiting goes. I am going to start educating the American people. I have a draft bill in because I am confident that under the demographics, with reenlistment dropping, in order to fill out this added effort here we need a draft.

Do you have any comment on that at all?

Admiral CROWE. We, of course are concerned, Senator, and we do follow it very closely. The drop in the figures that you refer to has not been alarming yet in the military but we are concerned. Actually, in the last few months, I think that our retention figures have held up better against national prosperity than they would have historically.

We believe that we have a pretty attractive package now for our people and we are succeeding better than we might have anticipated that we were.

Now, whether that will continue to be so or not, I do not know, but we follow it not only year by year, but we follow it month by month and day by day, Senator.

Senator HOLLINGS. Mr. Chairman, very good, I thank you.

Mr. Secretary, I hope that you understand the sincerity and friendship of my comments.

Secretary WEINBERGER. Oh, yes, sir, I do.

Senator HOLLINGS. I am cochair with Jack Kemp of the SDI Coalition and I believe in a strong defense but I am losing my credibility. Pete Domenici also wants a strong defense but he is losing his credibility too. Your friends around here are having a dickens of a time. Since you have come to Washington you have added 123,000 civilians to the Defense Department. We have beefed up defense. But people want to know why defense doesn't have to share in the sacrifice necessary to cut the deficit. Others, persons of repute like Secretary Laird, are saying, look this is too much money too fast.

Let me tell you a true story. I was campaigning in Houston after you folks had been in the administration 3 years. I met former Deputy Secretary of Defense, Charlie Duncan down there. He knew my work in defense so he asked me how much, in the 3 year period, had we increased the defense budget.

I said, $101 billion. Heavens above, he said, I ran that Department and there is no way physically to spend $100 billion in a 3 year period. That really hit me, and that is why I have got into explaining the difference between unobligated and unexpended funds. I agree with you, you have got to put the money there. It is just like it is spent. We do not think that a bunch of money is piled up but we see that is unexpended and then the unobligated increasing and you are asking for $30 billion more and the President is saying cut. All of the President's cuts, if you have included Reagan's fire sales, and Bonneville Dam and user fees, and everything else on page 3-24, only add up to $38 billion. That's not much considering you are asking for an increase of $34 billion in budget authority.

See what I am saying?

Secretary **WEINBERGER**. Sir, I know what you are thinking and I would be delighted if I could come before you honestly and conscientiously and tell you that we do not need what we have asked for.

Senator **HOLLINGS**. Oh, I believe that.

Secretary **WEINBERGER**. I cannot do that.

Senator **HOLLINGS**. I know you feel that way.

ONLY WHAT IS NEEDED IS ASKED FOR

Secretary **WEINBERGER**. I do have to fulfill those responsibilities, even though, as you pointed out, it is not the most popular task in the world. But it is something that we feel that we have to do and obviously your judgment on it is much respected and the congressional judgment collectively will control as it always has, but the point that we want to make is, that, first of all, we do not ask for anything more than we need. We have no point whatever in doing that.

We do ask that things be fully funded, because we can make the most efficient use of it then. Comments such as we have to be leaner and meaner and whatever those articles say and all of that, those are nice mottos, but the fact of the matter is that we think that we have been. We have been through very substantial budget reductions and I am prepared, if you and I have the time, and I see by the light that we do not, but I will give it to you, run through all the things that the services asked for, but we turned down. This was not because these were bad things but because we could not afford them.

We have a number of budget scrubs that go on all year, so we are making major efforts to do it. I understand perfectly what you are saying and I appreciate very much the spirit in which you say it. The President feels very strongly and I do agree that a revenue increase is not going to solve the problem. We have had major revenue increases even with the tax cut. But, as I mentioned, expenditures have gone up much more during this same period.

Senator **HOLLINGS**. But the President has signed into law an 18-percent cut in your and my defense budget come October if we do nothing.

Secretary **WEINBERGER**. Yes.

Senator HOLLINGS. If we just wrangle back and forth and if we do not get together it is going to be very, very difficult to change that law. You and I do not want any such nonsense to occur so we need to be a little bit more realistic and agreeable about this thing.

Secretary WEINBERGER. Senator, I try to be as agreeable as possible and I try to be as realistic as possible. I think that you are entitled to know and the people are entitled to know, the best estimate in the judgment of the people who work in it every day, not to say that they are right or wrong, but you are entitled to have that judgment and estimate as to what is required. I have laid that before you as best as I can, and I would advocate it because I feel very strongly and have worked for over 1 year to produce this particular set of requests.

But, obviously, you have other views and others are entitled to them, but I do think that you are entitled to know without a lot of varnish on it or without a lot of attempts for me to estimate what is politically possible, to tell you what is required in our opinion.

That is what is before you.

Senator HOLLINGS. Thank you, sir.

Chairman DOMENICI. Thank you very much, Senator.

Senator Exon.

Chairman DOMENICI. Thank you, Senator. Senator Exon.

Senator EXON. Thank you, Mr. Chairman.

Gentlemen, we were at breakfast yesterday and at Armed Services. I'm try one or two new ones on you.

Thank you, my friend from South Carolina for bringing up what you just did. I told both of these gentlemen the same thing that you just told them, both at breakfast yesterday and in front of the Armed Services Committee yesterday.

OIL IMPORT TAX NOT FAVORED BY DOD

Let me ask the question this way: Supposing, Mr. Secretary that we drummed up—let's be specific—an oil import fee, which is a tax, but it's called a fee. Supposing we dreamed that up for $1 a barrel or $5 a barrel, or $10 a barrel, or $50 a barrel. Or anywhere in between, and we took that money and we dedicated that to meet the defense needs that you and others say are necessary, and for a large part, you know that I agree with you.

What would you think of that proposition? Would you enthusiastically support that?

Secretary WEINBERGER. I enthusiastically support what would bring additional funding into defense to meet the needs I think are there, Senator. I would have to tell you that I do not favor an oil import tax. I don't think it's a good thing for the country.

Senator EXON. Well, then take some other kind of a tax where we could dedicate it to this proposition. Would you be for any increases in taxes under that kind of a scenario?

Secretary WEINBERGER. I'd be very much afraid, Senator, and I'm not trying to dodge your question. I'd be very much afraid of the adverse effect on the economy of tax increases. We've had such a good effect on the economy from tax cuts that I think we can afford the defense we need within those funds. When you have the increase in revenue that we've had, with the tax cut, and when defense has only taken a third of that, and will take less than a third next year, I think we can afford it within the tax structure we have.

I do feel very strongly about that.

Senator EXON. Maybe we can lay to rest these continued discussions about how much we're spending percentage wise over or allies, and we can go on and on with that. I guess you would agree, would you not, Mr. Secretary, that over the last 5 years, for example, under any scenario or any arithmetic, we have spent percentage wise far more in the increase of our defense budget than any of our allies?

Secretary WEINBERGER. Since 1981, yes, sir; not before that. Before that we were well behind.

Senator EXON. Well, that kind of puts it in perspective. We just can't take 1 year.

Secretary WEINBERGER. No; that's right. There's never been a meeting of our allies that I've attended, and I will call them all as my witnesses, in which I haven't said that we all need to do more.

Senator EXON. We haven't got time for them.

Let's talk about operations now, just a moment. I believe you have testified, or I believe it's true that in the budget that the President is proposing, you have what you need without making any sacrifices whatsoever in MX, in Midgetman, in the B-1 bomber, and SDI, in Stealth, and all the important black box programs.

Secretary WEINBERGER. We've tried to protect those, yes, sir.

RESEARCH FUNDING REQUESTED FOR TANK WEAPON

Senator EXON. All of those programs. What have we done, if anything, and it kind of jolted my memory when you said a few moments ago that we'd be surprised to know what the services asked for that you turned down. Let me ask this question: Did you turn down the customary request that's been ongoing for some time—and I've been involved with this for a number of years—and that is with regard to the infantry not having a field weapon, bazooka-type weapon, with which we could stop Soviet tanks.

That concerns me a great deal, as it must you, given the 3½ to 1 superiority in the NATO front with regard to Soviet and our tanks.

Did the services request any kind of expenditures for research and development on a killer field tank weapon? If they did, did you approve it, or was it cut out?

Secretary WEINBERGER. I'll have to get you the precise answer, Senator, to be certain about it. My memory is that there was a request, and that it was granted in part.

Senator EXON. In part.

Secretary WEINBERGER. Yes; it's a research and development item because it is necessary to try to develop that kind of system that you want, that I want, and that is necessary.

Division Air Defense, as you know, we cut out, not because we don't need the capability, but——

Senator EXON. But the thing didn't work.

Secretary WEINBERGER. Yes; it didn't work. We're trying to now get one that does But on the tank weapon, we have requested research funding, and I'd have to get for you whether or not more was requested than we granted.

My memory is that there was a bit more, but I'm not sure.

Senator EXON. I'd like to have that, because I happen to feel down deep in my bones that that's equally important with all those other important programs.

Secretary WEINBERGER. It's very important.

[The following was subsequentially supplied for the record by DOD:]

ANTIARMOR WEAPON SYSTEM—MEDIUM

I supported the Army's request to develop a new anti-armor weapon for the infantry. The FY 1987 budget request contains $48.7 million to continue the development of a weapon for the infantry which will be capable [deleted]. The FY 1987 funds will continue the advanced development of the weapon which will be initiated in FY 1986 with the $60.3 million appropriated by the Congress. This new weapon, Anti-Armor Weapon System-Medium (AAWS-M), will replace the DRAGON missile. The DRAGON missile is currently in the inventory as the primary man-portable anti-armor weapon. [Deleted.]

Senator EXON. Maybe sometimes we overlook those more mundane, less exotic things, which I think are tremendously important as far as a conventional war.

NO MILITARY STRIKE PLANNED

Last question: There is a great deal of muscle flexing going on in the Mediterranean today with regard to our fleet, Mr. Secretary. That gets us into the realm of terrorism. I suspect that if we take some action against terrorists, if it's not the CIA, the forces under your command would be involved. Can you tell me, first, if the muscle flexing now in the Mediterranean, especially with regard to the Sixth Fleet has anything to do with a potential or possible military strike against Qadhafi; and, second, in your budget, did you make adequate provisions to beef up our antiterrorist activities over which you have a considerable control?

Secretary WEINBERGER. The answer to the second question is we think we made, within the total budgetary constraints that we have, adequate requests for that.

With respect to the first question, no. What the fleet is doing in the Mediterranean is exercising in international waters, as we have a right to do, and as we have always done. We've been in the Mediterranean for a century or more, and we will still be there; we have to be there, and we will stay there. We're exercising in areas that we believe and we know are international waters.

Some of those waters are there under an absurd claim of Libya, out many, many miles beyond anything that we or anyone else recognizes.

But we are exercising the fleet, maneuvering it in international waters, and will continue to do so.

Senator EXON. Not in preparation for any kind of military action.

Secretary WEINBERGER. No; it is not.

Senator EXON. Thank you. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

Senator Lautenberg, I understand you have a couple of questions.

Senator **Lautenberg**. I'll try to make them short, Mr. Secretary. Mr. Chairman, I would appreciate that.

Chairman **Domenici**. Would you mind if I asked a few questions and I'll be with you here for a few minutes.

Senator **Lautenberg**. Certainly.

Chairman **Domenici**. Mr. Secretary, I'd like to make a couple of observations. I think maybe you stated in the record, you made a statement with reference to negotiating for a defense number, but in the past there was nobody you could rely on.

Secretary **Weinberger**. I just said nobody had the authority to sign an agreement.

Chairman **Domenici**. Let me make sure that the record is clear on that. The Secretary is alluding to the fact, as I understand it, that even if we end up with a budget authority figure in the budget resolution, and if that's agreed to by those parties that are participants in that, and even if that budget resolution is then voted in, that by the time it goes through the appropriation process, in only one of the 5 years have we appropriated the level of budget authority that was so agreed to. That's what you're talking about?

Secretary **Weinberger**. That's one of the things, yes, sir.

BUDGET RESOLUTION NEVER BROKEN

Chairman **Domenici**. I think it is fair to say that in every one of those years where the budget authority that was agreed to in the form I've just described, in every year that it was not appropriated to defense. It was spent. That is an interesting thing. It has been a very big discussion topic here in the Congress.

But everyone should know that when we did reduce irom the budget resolution—not the President's request—the budget authority level for defense, all of that was spent in the budget somewhere else. Is that a fair statement?

Domestic programs used it up. I don't know that we make that statement frequently enough, because the conclusion that is made is we never—we never break the budget resolution. But sometimes we cut defense $20 billion and we spend it somewhere else. That is Congress' prerogative under the current budget laws. It will be more difficult under Gramm-Rudman, because subcommittees of appropriations will be bound in their allocation as to both budget authorities and outlays.

But that is true. When we saved, we didn't end up reducing the deficit any.

Now, having agreed with you on that, and making the position that it was not this Senator, nor Howard Baker nor Bob Dole that you could not get the ultimate agreement from, but rather that as the process has proceeded through there were other players who saw it differently.

I would conclude that if we strike a deal this year, and hopefully we will, and I don't ask you to comment on that, that we ought to clearly bring everyone into the process.

But it just won't be made with authorizers and budgeteers, but bipartisan, if we end up getting it. Bicameral and what's the next layer—multicommitteed? Now we've really got them all.

We ought to try that this year if we're going to strike some deal.

Now, let me say I don't agree with you on the relationship of taxes to this budget process, nor do I agree that the President has been conned.

"THREE FOR ONE" DEAL NOT DECEIVING

I was part of the so-called three for one deal. Obviously, I would never agree, having been part of it, that I would participate in deceiving the President.

As a matter of fact, the truth of the matter is that there are pieces of paper that were circulated when the President agreed to TEFRA I, Mr. Secretary, that Congress did precisely what it committed to do.

So at least from this Senator's standpoint, the President's argument about "I was supposed to get three for one and I didn't and, therefore, I will never again agree to taxes," let me just make it very clear, that doesn't carry much water with me.

Because I really was part of it. If the President understood it differently, that's somebody else's problem. But we did what we committed to do. It happens that later on he agreed to do some other things that raised spending, and it also happened that interest rates did not come down as projected, and consequently savings did not arise.

But you do that all the time, too, because you put inflation in your budget and then you don't need it.

Secretary **Weinberger**. That's only one of the reasons he's against taxes, and he knows and I know that you have behaved honorably in this, completely, as you always do.

All I'm saying is it's very hard to make an agreement without any authorized agents. That's been the problem we've had.

Chairman **Domenici**. I'm agreeing with you on that.

Now, I want to make one other point, because I consider that from time to time the President relies on you for matters outside of defense. You're part of a group that advises him.

I have great respect not only for the way you have learned this job, but I know you have vast experience. You've been a budget director before You could even write economics. Given a little bit of time you could talk about Keynesian and supply-side and the like.

But let me tell you: Even you could not sustain the statement that an increase in taxes to pay for defense spending, if we had the rest of the budget in order, of $10 to $15 billion is going to substantially increase the chances of the economy going down.

TAXES WILL INCREASE $144 BILLION WITH PRESIDENT'S PACKAGE

If you agree with the President's tax reform package, and I will not ask you to answer—I will just ask you to listen and then you think about it—when he asks you the question, that tax package in 5 years will increase taxes $144 billion on one whole segment of the American economy, from a day of current law to a day 5 years later when it is completed not 12 or 15, but $144 billion.

Huge sectors of the American economy will have $144 billion new taxes put on them. Those who support it, and conversely say we should not pay for a piece of defense needs with taxes, will say the one will increase our economic prosperity, and the other will cause some kind of ruin.

Now, that, to this Senator, is incredible. There is no relationship in any body of economics that leads me to believe that. I only say it because to add insult to it, if the administration would go even further and say, oil import fees, they aren't good. You don't like them. Senator Lautenberg doesn't like them. They will be very harmful if we put them on and pay for a part of our defense increase. But they will do no harm if you put them in the tax reform package. That, to me, makes no sense.

I mean, that concept of tax neutrality in that big package does not negate the fact that you have put oil import fees on. We ought to look at them from the standpoint of whether they are good or bad, harmful or not to the economy; and not stretch any economic credibility that in an $800 billion tax pool, adding that source of revenue to maintain neutrality will make the tax reform very good, but separate and apart from it, very, very harmful.

Now, having said that, you know that I clearly think we need some defense increase.

Let me tell you, I don't know if that number you want is right. We always will argue about it. You've got some real problems that you haven't had before, and you're sensing them.

DOMESTIC CUTS WILL NOT PAY NEW DEFENSE OUTLAYS

But, there is no chance, in my opinion, no chance that you're going to pay for 30, 35, 40, 45 in new defense outlays and get it all from cutting domestic spending. I can't tell you that any stronger.

I mean, I would bet that one 50 to 1. It just won't happen.

Now, having said that, that's the essence of the President's approach. You pick up the savings in domestic, and those who are saying what's going up? Defense is going up. So you're paying for the defense with the domestic cuts.

Now, you can't do that. You might get half of it, you might get 60 percent of it, and you might need your defense. You have to think with those who advised the President that there's got to be a way to do that, got to be. We can't let you, the defense of our country, take a 15- to 22-percent cut in August of this coming year. Impossible.

Now, to underscore how tough your problem is, I couldn't believe my ears, and I don't think it's at all betraying any confidence to tell you the toughest part of sequestration, the first little round, the 4.3 that we had to take in domestic, and what was yours, 4.6?

Secretary **Weinberger**. 4.9.

FLEXIBILITY RETAINED FOR UNIFORMED PERSONNEL

Chairman **Domenici**. Believe it or not, there were staunch supporters of defense who said no flexibility. Take it out of everything. Because they don't believe, they don't believe that you are really in need of all the money that's in the department—so they say. The only way they will understand is to take it out of everything.

You know, those of us who were worried got you the flexibility on personnel—in case you're wondering why personnel, not all personnel, uniformed personnel, as I recall, were the only ones excluded. Is that right?

Secretary WEINBERGER. That's right.

Chairman DOMENICI. We said that's got to be dumb. I mean, why do we want to hurt the military to prove a point? You can't be firing people, so can't we give them flexibility on personnel? It took us 2 days of negotiating with staunch supporters of defense because there was some kind of lesson that somebody had to learn, they thought.

Now, I don't know if there's a lesson to be learned, and I'm telling you this because I really am concerned. This whole issue of unobligated balances and unexpended balances has to be understood by us, and I assure you it can not be mysterious.

I look back there at my good friend, Bob Helm, and Senator Hollings even—any implication that his leaving was result of our not having enough money, that we let him go, let me say that's wrong. I mean, you stole him.

Secretary WEINBERGER. I'm glad we were able to, Senator.

Chairman DOMENICI. Not you, but the National Security Adviser first. So we'd still have him here.

But we need to understand, and I say this, Mr. Helm, that we've got to know what these unobligated balances and the others mean, because they're at the heart of what I'm just describing.

No, don't tell defense to cut $10 billion because they won't cut anything. You see, that's what they're saying. So that's why you've got your 4.9, Admiral, in case you're wondering. That's precisely why.

It's going to cause you a lot of trouble. The thing is we know the next time it's going to be 18.

Admiral CROWE. It's going to cause us a lot more trouble.

Chairman DOMENICI. You can't live with it. I've even written that you couldn't do that. I mean, the world wouldn't let us and the President wouldn't let us.

So I've said perhaps more than I should in this regard these last few moments, but I feel very strongly about it.

I also don't believe that we can sit around as we have some other times, 2, 3, 4, 5 months, and let this thing simmer.

That's the end of my statement.

Secretary WEINBERGER. Senator, you're kind to ask me not to comment, and I appreciate that at the close of a long day, but I would like to say that I don't believe the President has that kind of understanding of the tax reform package that you've mentioned.

NOT PLAYING FAST AND LOOSE WITH NATIONAL SECURITY

Second, I would also like to say that I think the national defense, and the national security is far too important a matter—as I know you do——

Chairman DOMENICI. Absolutely.

Secretary WEINBERGER. To play fast and loose with a lot of numbers and a lot of games to try to achieve a result that can be achieved by a reasoned approach to it.

When we say that what recommendations we have for priorities, and what recommendations we have for reductions, they are in the budget, and if it is necesary to reduce more, then we would do it along the lines that we've told you, that is, we would protect strategic defense, we would protect strategic modernization, we would protect military personnel. That doesn't leave you a great many areas where you can make your cuts, and they're all undesirable.

But there's no mystery about it. There's nobody tryinq to, on our side, trying to play fast and loose with the Nation's security. I think those that do can't really be described as strong suoporters of defense.

Chairman DOMENICI. Mr. Secretary, I agree with you. However, I don't believe that you really mean that in a department this large, with multiyear budgets, assumptions, economic estimates, inflation estimates, estimates of attrition and all the other kinds of things that are in there that literally it's as cut and dried as you just stated. It isn't.

Secretary WEINBERGER. The reductions that we've made have come out of all of the things you've mentioned and more.

Chairman DOMENICI. Yes, indeed. But they have been to some extent much larger cuts, especially the last one, when you combined less than zero and then 4.9, nobody planned that, you understand.

Secretary WEINBERGER. Sure.

Chairman DOMENICI. Senator Lautenberg.

Senator LAUTENBERG. Thanks.

Mr. Chairman, listening to your treatise on taxes here encourages me, because not only has your disposition improved since you stopped smoking, but your wisdom as well.

Chairman DOMENICI. Thank you very much.

It's just that you didn't know about it before.

Senator LAUTENBERG. I was coughing before and I couldn't pay attention. [Laughter.]

Exon's doing it, too. [Laughter.]

Mr. Secretary, I'll try to not hold you too long. I know you're getting close to overtime, and I want to reduce overhead.

Chairman DOMENICI. You're getting better also.

Senator LAUTENBERG. I finally got some time.

Chairman DOMENICI. You're even funny once in a while now.

Senator LAUTENBERG. That's what I used to do before I came here.

Mr. Secretary, one of the ways of reducing overhead you mentioned was to rely more on fixed price contracts.

Secretary WEINBERGER. Right.

Senator LAUTENBERG. But I note that there has been an increasing use of unpriced orders, at least from the years 1982 to 1985. The Navy's unpriced orders have tripled. The Air Force doubled between 1984 and 1985 unpriced orders. There is a $13 billion backlog. In total, DOD has $28 billion in unspent funds for unpriced orders. Doesn't that fly in the face of your concerns or your ability to reduce costs?

UNPRICED CONTRACTS BEING REDUCED

Secretary WEINBERGER. Well, actually it doesn't, but it is a bad practice, Senator, and it is one that we are reducing very substantially and very rapidly. What unpriced orders involves, as you know, is a situation in which we go ahead and get an order coming in before the complex negotiations on the contract as a whole have been compieted, and the reason that I don't think that it has the adverse effect that it could have is that we use it within a fixed ceiling, that is to say, that we'll sign an unpriced order and you can go ahead and deliver, and we'll pay for certain of these items, but it has to be within a ceiling which in turn is within the contract ceiling.

But it is not a good practice, and we are reducing it, and it is done when it is needed to get some things right away, and the negotiators have not been able to agree upon a contract price.

Senator **LAUTENBERG**. So the direction is more toward the fixed price contract.

Secretary **WEINBERGER**. Absoultely, yes, sir.

Senator **LAUTENBERG**. Sometimes, I know, we have to go to a sole source and experienced contractor, but another factor that you said might improve or reduce overhead was competition.

Secretary **WEINBERGER**. Yes, sir.

PROPOSED MERGERS LOOKED AT VERY CAREFULLY

Senator **LAUTENBERG**. Mr. Secretary, have you looked at the GE-RCA merger with any concern about the ability to invite competition when GE is number six in terms of the largest defense contractors, and RCA the 22d. These are very good friends of mine. They're in the State of New Jersey, and do very well by us.

But the merger would make them the fourth largest purveyor of services and materials to the Defense Department. Does that concern you at all?

Secretary **WEINBERGER**. Well, certainly it concerns us, Senator. It should and it does, and we are asked to comment frequently by the Department of Justice or Federal Trade, depending on which one has authority or jurisdiction over the proposed merger.

We look at those very carefully, and we turn in our comments on them. Sometimes those are followed, sometimes not. But it is a matter of concern. But even within combinations of that kind, it is still possible to get substantial competition.

We have competition now, for example, on the fighter engine from United Technologies, Pratt & Whitney, and GE, which we didn't have before. The mergers that have taken place don't affect that, for example.

But we do look at the proposed mergers. We're asked to comment on them, and we look at them from exactly the point you've made. Not only whether it would reduce competition, but whether it would produce an unhealthy dependence on too few a number of manufacturers.

Senator **LAUTENBERG**. In that connection, I wanted to ask you this: Admiral Crowe, in your statement, it says the integrated Aegis system is at sea and exceeding expectations in missile kill capability.

Admiral **CROWE**. Ability to track targets and detect them.

REPLACING SUPPLIERS INVITES PROBLEMS

Senator **Lautenberg**. It's a very positive result. It's a very efficient system. Now, we have a supplier of that system, a systems coordinator. It's a very complicated piece of business coordinating all the components in a system like that.

I would ask you, this performance record suggests, doesn't it, that the present supplier has done a good job in terms of the system coordination necessary to make this a piece of equipment that has the capability you described?

Admiral **Crowe**. Essentially yes, sir.

Senator **Lautenberg**. The reason I ask that question is there is an attempt now, as I understand it, to replace the present supplier. Having been in the computer and systems business before, I would urge you to take a very close look at that. Once you start fiddling with that, once you get a new systems manager, it often invites lots of problems. If you would, please, I would like to very briefly, Mr. Chairman, touch on a couple of other things. Mr. Secretary, certainly you would appreciate nontax revenues, would you not, coming into the revenue stream of the country?

WORK DONE ON NONTAX REVENUES

Secretary **Weinberger**. We did a lot of work on nontax revenues, and we produced substantial additions from that, and various changes that were made over the years. It is a way of increasing revenues, yes.

Senator **Lautenberg**. I would urge, Mr. Secretary, with your substantial influence downtown that you encourage the administration to look at some of the nontax revenue opportunities proposed by Senator Lautenberg and Senator Moynihan and a few others on uncollected taxes.

Secretary **Weinberger**. Certainly nobody has any problem with collecting uncollected taxes. Some of the other nontax revenues are things that involve changing charitable contributions, mortgage interest deductions.

Senator **Lautenberg**. Well, those increase taxes. I'm talking about old loan portfolios.

Secretary **Weinberger**. That's right. Increasing collections of all kinds, both taxes and delinquent loans is a vital thing.

We're doing a great deal of that with delinquent loans on the education side now, particularly those that are held by people in the Defense Department.

Senator **Lautenberg**. Mr. Secretary, all of us were terribly shocked, saddened by the shuttle **Challenger's**, demise. It's going to affect us emotionally for a long time. But it also will have an effect on the budget.

OTHER POSSIBILITIES BEING VIEWED

Have you come to any conclusions about what the unavailability of that shuttle might mean to your needs for launches?

Secretary **Weinberger**. Sir, we haven't come to a definitive conclusion yet. We're, obviously, looking at it very carefully. We have lost a lot of shuttle capacity along with the terrible tragedies that occurred.

We are looking at the possibility of using expendable launch vehicles for some of the payloads that could be accommodated on them, some of the older retired missiles. We are also—and my understanding is NASA is looking at the possibility of another shuttle that was not contemplated when they originally—before this loss, of course.

We are trying to find what effect it would have on the strategic defense, because there are a number of experiments there, part of the research program that were going on some projected shuttle flights several years out.

At the moment we don't think it will be terribly serious in that connection though, obviously, there will be an effect on it.

But we have not, we are not yet in a position to tell you any budgetary implications from the Defense Department's point of view and, obviously, since that is a NASA project they would be looking at the question of replacing the whole lost capacity.

Senator **Lautenberg**. Thank you, Mr. Chairman.

Chairman **Domenici**. I do want to tell you, Senator Lautenberg, while collecting uncollected taxes if admirable and we should all be for it, there are few economists who would judge the negative or positive effect of revenues depending on whether they are the result of collecting uncollected or collecting those that you collected.

So if you collect enough, it will have an adverse effect on the economy.

You believe that, don't you? That's what economists who say the other thing you've been talking about say, so——

Senator **Lautenberg**. Well, we could argue that. I think that we ought to do that in connection with an amnesty program which I recommended. We'd get them on the tax rolls.

Chairman **Domenici**. Listen to you. We've got to go.

Senator **Lautenberg**. It's part of a broader set of proposals.

Chairman **Domenici**. Senator Exon, you want to ask one?

Senator **Exon**. One question.

Chairman **Domenici**. Go ahead.

Senator **Exon**. Mr. Secretary, I'm going to try once more, after breakfast, and after yesterday, and after the questions today along the same lines as Senator Hollings, Senator Domenici, to try and do what has been suggested here, and I suggested yesterday to use your influence.

Let me put it this way: Several Senators have been to the White House. It's been widely reported in the news media, and the Senators have told me about this. The President says that the Soviets are watching the budget actions and deliberations. The President says anyone that doesn't follow his mark on defense is helping the Soviets and hurting him in his future negotiations with them.

Now, given all this talk, and if it is true, would it not be in the interests of national defense if the President would not agree to some kind of revenue increases if all else fails, taking it out of social programs, wouldn't it be in the interests of national defense, and in his favor in strengthening his position in dealing with the Soviets if he would agree to some reasonable kind of revenue increases if that's the only way to get the job done to give him a strong hand with the Soviets?

Or is the President saying, if I can't get it out of social programs, the Soviets win? Is he going to allow them to win also by continuing to refuse any kind of revenue increases?

Is that not irrational, that position?

Secretary **Weinberger**. Senator, the President will never allow the Soviets to win.

Chairman **Domenici**. Thank you very much.

On that note, we're adjourned.

[Whereupon, at 5 o'clock p.m. the committee was adjourned.]

WRITTEN COMMITTEE QUESTIONS TO WITNESSES AND THE RESPONSES

Military Retirement

Question: What proposals are being considered to reform the military retirement system? What reforms would you support?

Answer: On November 15, 1985, the Department of Defense submitted a report on the military retirement system as required by section 667 of the Defense Authorization Act for fiscal year 1986 to achieve a $2.9 billion reduction in authorizations for retirement accrual funding. Included with the report were drafts of two changes to the present system that would result in the mandated reduction made by the Congress for fiscal year 1986. This is a 16 percent reduction in military retired pay from the current system and is in addition to the 13 percent reduction imposed by the Congress in 1980.

The required submission included a structure-only option and a combination option. The structure-only option based retired pay calculations on a high-5 year basic pay average, reduced year of service multipliers from 2.5 percent per year to 2.15 percent for years 1 to 20 and 3.2 percent for years 21 to 30. Retired pay adjustments would be in relation to percentage increases in the Consumer Price Index (CPI), as currently exists. The combination option uses a high-3 year average of basic pay for calculation purposes with reduced multipliers of 2.2 percent per year for years 1 to 20 and 3.1 percent per year for years 21 to 30. Non-disabled retirees would receive retired pay adjustments based on percentage changes in the CPI minus one for life with restoral at the 40th anniversary of entry into service. The CPI minus one percentage point would again be operative after the restoral calculation.

Although the Department of Defense was required by Congress to provide the two legislative options, such action does not constitute support for either of the options for change. To the contrary, the Department of Defense is steadfastly opposed to the significant degradation in future combat readiness that would result from the changes required to achieve the mandated reduction. We believe that the present system is working well to achieve our objectives and that change is not required.

TACTICAL AIR FORCE

QUESTION: A 1985 CBO study indicated that the Air Force 40 tactical air wing goal could have been attained by 1991 if the service life of the F-4 was extended. The study also said that such an alternative would produce a more capable force than a smaller one with more top-of-the-line aircraft, and at a savings. Yet this years budget slips the forty wing goal out yet again. What does the administration plan to do to get more tangible results for tactical defense expenditures?

ANSWER: Both the FY 86 and FY 87 President's Budgets project tactical force growth to 40 tactical fighter wing equivalents by FY 91.

Light Infantry Division Initiative and Deficit Reduction

QUESTION: In view of impending deficit reduction measures, has the Office of the Secretary of Defense considered re-evaluating the wisdom of the Light Infantry Division initiative, as recommended by the Assistant Secretary of Defense Lawrence Korb in August 1985?

ANSWER: As you know, we review annually all aspects of our Five-Year Defense Plan. Both the Program Review in the summer of 1985 and the Budget Review in the fall of 1985 retained all actions proposed by the Army to implement the Light Infantry Division initiative. As you also know, both the size of any possible future funding reduction and the extent of our ability to chose the areas to absorb the reduction are matters under consideration by the Congress and the courts and, as such, it would be best not to speculate on future actions in these areas.

QUESTION: Could the strategic requirements for Light Infantry be satisfied by the planned conversion of the two existing Infantry Divisions at Fort Ord, CA, and Schofield Barracks, HI, foregoing the creation of two new divisions and the attendant military construction costs of almost $1 Billion?

ANSWER: For some time, our strategy has not been matched by adequate capability. The President and I have concluded that activation of the new divisions is an appropriate and affordable step in bringing our capabilities and strategy more in line.

SHORT RANGE AIR DEFENSE

QUESTION: How is DoD planning to fill the void created by the cancellation of the Sgt. York program, particularly in the near term?

ANSWER: An extensive analysis of the threat, assessment of technology, and examination of existing systems (prototype and production) has been completed. The Army has revised its counter air concept to call upon all elements (friendly air, Army combined arms, and Army air defense artillery) capable of contributing to the reduction of enemy air's effectiveness. A family of systems for air defense artillery, Forward Area Air Defense (FAAD), has been defined. It includes line-of-sight (LOS) and non-line-of-sight (NLOS) weapons to defeat rotary and fixed wing aircraft and a command, control, and identification system to tie it all together. The development of the non-line-of-sight system to defeat helicopters not in line-of-sight to the weapon will be expedited; the technology has been demonstrated. Further analysis and evaluation are under way for the selection of line-of-sight systems for division forward (LOS(F)) and rear (LOS(R)) areas. Non-developmental (off-the-shelf) items are being examined in greater detail to afford the opportunity of an accelerated fielding. Near-term approaches to the solution include changes in doctrine and training to make the most of collateral capabilities available in existing weapons, fielding of Product Improved Vulcan (PIVADS), and restructuring of the heavy division air defense battalion to maximize its capability with the current weapon system and to expedite its conversion to FAAD systems.

SHORT RANGE AIR DEFENSE

QUESTION: What is being done to improve the Guard's air defense capability? What air defense is planned for the Light Divisions?

ANSWER: The fielding of Chaparral to the Army National Guard (ARNG) is continuing; a total of six battalions is planned. Also, three HAWK battalions and the FAAD Line-of-Sight (Rear) weapon system will be fielded in the ARNG. The FAAD Line-of-Sight (Rear) systems will be fielded concurrently with their fielding in the active component. For the Light Divisions, we plan to field the FAAD Line-of-Sight (Rear) system, a light derivative of the FAAD Line-of-Sight (Forward) system and part of the FAAD Non-Line-of-Sight system.

SHORT RANGE AIR DEFENSE

QUESTION: Do you intend to seek reprogramming authority to use some of the DIVAD funds for procurement of Chaparral?

ANSWER: Yes, to procure the final 40 fire units necessary to complete the Chaparral program for the Army National Guard.

NATURE OF GROUND FORCES

QUESTION: (Mr. Weinberger)
"The Annual Report to the Congress has indicated that 52 percent of our ground combat forces are now considered light forces. Furthermore, you recently approved the requirement for five Army light infantry divisions designed for 'preemptive intervention' or, as the Chief of Staff of the Army has said, designed to 'arrive in a crisis area before a conflict begins.' Can you explain why there is an apparent swing in administration policy away from deterrence in Europe toward intervention in the third world, why 52 percent of our ground forces are structured in support of this strategy, and why such large increases in defense spending continue to counter these third world threats?"

ANSWER:
The formation of the Army Light Infantry Divisions is being carried out at the same time that the modernization of our heavy forces is resulting in a significant increase in their overall warfighting capability. Additionally, the Light Infantry Divisions would have high utility in the increasingly urbanized areas of Western Europe. They could and would be deployed there should the need arise. We are not "swinging away" from deterrence in Europe. In fact, we are working hard to increase it.

Deterrence in Europe alone, however, falls short of what our National interests require of us. A Europe free of Soviet dominance remains critical to the US, but the same is true of many other areas in the world. The Soviet defense build up is too large to be merely defensive. Soviet adventurism has gone well beyond the European Continent. They have increased their power projection capabilities, and they continue to attempt, either directly or through surrogates, to expand their influence worldwide. We must be capable of deterring and, if necessary, confronting and defeating this expansionism wherever and whenever it occurs. This has generated the requirement for us to be able on short notice to rapidly deploy highly trained forces to almost anywhere in the world.

The Army Light Infantry Divisions are being formed as a result of this requirement. They will be uniquely trained, and they are designed to be rapidly deployable by air transport. The existence of these divisions, with their potential of being deployed quickly enough to diffuse a crises before it escalates, should add significantly to the uncertainty in the minds of Soviet and other planners and decision makers and, therefore, to the deterrence of hostile military aggression worlwide. Should deterrence fail, the rapid deployment of one or more of the light divisions could well mean the difference between a protracted conflict and early conflict termination on terms favorable to us, our allies or friends.

GRAMM-RUDMAN-HOLLINGS?

Question: As one element of the flexibility it granted to DOD for FY 1986, Gramm-Rudman exempted military personnel from the recent sequester. The DOD comptroller, Robert Helm, asserted that without that provision DOD would have had to reduce force manning by 280,000 people in 1986. But under current law that flexibility will not be available for FY 1987 and beyond. Yet DOD might face an outlay sequester of $25 billion or more for FY 1987, which could mean sequestering $60 billion in total DOD budgetary authority.

1. If DOD could choose how to sequester funds within each appropriations account (such as Military Personnel -- Army), how would you comply with a FY 1987 sequester of $20 billion in budgetary authority for military personnel?

Answer: The extent to which the Gramm-Rudman Act will trigger automatic spending cuts in FY 1987 depends largely on the actions of Congress. The President's budget meets the FY 1987 Gramm-Rudman deficit target of $144 billion. Under this budget, there would be no need for cuts in military personnel. If a reduction of $20 billion in military personnel were required it could result in a virtual elimination of discretionary allowances so vital to attracting and retaining the best people and could also require a disastrous reduction to our force structure.

Question: If you were given similar authority for FY 1987 to that you had for FY 1986 to exempt or limit the sequester of military personnel appropriations, would you use that authority in FY 1987 as you did in FY 1986? That is, would you exempt military personnel appropriations even at the cost of imposing a larger sequester upon the operations, procurement, and R&D accounts?

Answer: People are our highest priority and it greatly worries me that flexibility does not exist in FY 1987 to protect manpower programs should a sequestration become necessary. If such authority existed the President would most probably take advantage of it to some degree. However, there are too many variables to try to forecast at this time what might be done for FY 1987. We would hope the Congress would approve the President's budget and avoid invoking the provisions of Gramm-Rudman.

Question: If you had flexibility in the law to reduce rates of pay, would you choose to comply with a $20 billion sequester of budgetary authority for military personnel in FY 1987 in that way rather than by reducing end strength?

Answer: We remain committed to the principle of comparability and have fought hard for fair and equitable pay increases for our military personnel. If the Department had the flexibility to reduce rates of pay, I do not believe we would elect to do so and reverse all of the compensation gains we have made in recent years.

DEFENSE INFLATION

Question:

DOD or OMB has decided to use the GNP inflation rate for major systems when it prepared the budget request whereas last year 130 percent of the GNP inflation rate was used for major systems.

1. How much difference did this change make in the amounts requested for major systems procurement?
2. How were the savings generated by this change in policy applied? Were they used to reduce the total funding that DOD requests or were they instead applied to increase the budget request for other DOD appropriations accounts?
3. What reductions can be attributed to the fiscal years 1988 and 1989 DOD budget as a result of this change in policy?

ANSWER:

1. Major systems in the DOD budget are priced at GNP rates in FY 1987 and in the DOD topline for the outyears (FY 1988 - 1991). The impact of using the GNP rates rather than a factor of 1.3 times the GNP rate is as follows:

FY	$ Billions
1987	1.9
1988	2.6
1989	3.2
1990	3.7
1991	4.2
Total	15.6

2. The savings generated by the policy change were used to reduce the total funding in the DOD request and were not applied to program growth. The DOD Topline for the years FY 1987 through FY 1991 in the FY 1987 budget request was reduced by $89.0 billion from the Mid-Session Review in August 1985. The inflation changes were a component of the total Topline reductions.
3. The reductions in FY 1988 and FY 1989 is a result of the change in policy amount to $2.6 billion and $3.2 billion respectively.

Military Pay Raise

Question: What would be the effects on recruiting and retention of foregoing the proposed military pay raise in FY 1987?

Answer: We estimate that eliminating the 4 percent military pay raise in FY 1987 would result in a loss of 9,500 members in the career enlisted force and a loss of 12,700 in the number of high school diploma graduates (HSDG) we would be able to recruit. Unless the pay freeze is restored, by FY 1991 we estimate the career force would be 43,700 less than currently planned, and the total loss of HSDGs over the period FY 1987 to FY 1991 would be 60,300.

Question: What would be the savings from using enlistment and reenlistment bonuses to meet personnel needs, instead of an across-the-board raise?

Answer: We cannot estimate with precision the savings from using enlistment and reenlistment bonuses, instead of an across-the-board raise, to meet personnel needs because the total cost of the initiatives that would be required to offset the elimination of the pay is highly uncertain. We estimate that approximately $1 billion in enlistment and reenlistment bonuses alone would be required just to offset the immediate and direct adverse effect on enlisted force manning. When consideration is taken of the further steps which would be required—such as bonuses and other programs necessary to offset the impact on the officer and reserve forces and dealing with the personnel losses resulting from the reduction in the value of future retirement benefits—we believe that such a full and accurate accounting of the costs would produce net savings which would be marginal at best.

Question: In view of the budgetary stringency confronting the federal government, why didn't DoD propose these more efficient programs instead of a 4 percent raise?

Answer: Military pay raises have been capped in each of the past four years, creating a cumulative gap of about 8.3 percent between military pay and private sector wage growth. We believe that as a matter of equity, and for long-term force manning considerations, it is important that military pay not fall further behind in FY 1987. The 4 percent military pay raise that we have proposed matches our estimate of what civilian wage growth will be. In regard to bonuses, we believe that they are a useful tool for management of specific skill areas and may also be used in the short-term to mitigate the effect on the force of pay caps or pay freezes. However, we believe there is a practical limit to the use of bonuses as a substitute for pay raises over an extended period of time. Carried to its absurd extreme, the entire military base compensation structure would be abolished and the entire pay would consist of bonuses. Further, a radical expansion in the bonus program, at the expense of basic pay, erodes the institutional values of military service. While we may be able to "buy" military personnel in this way, we should not count on it to produce an optimum force structure.

THE DEFENSE BUDGET AND THE DEFICIT

QUESTIONS: (Mr. Weinberger)

1. "What security risks would the U.S. be running if the defense budget was held to zero real growth over the next five years? If the defense budget declined in real terms by 2-3 percent a year over the next five years? Would the risks of war be dangerously high?"

2. "What advice would you give President Reagan and his successor about coping with the Soviet threat under potential Gramm-Rudman defense budgets?"

ANSWERS:

1. The success of our National strategy of deterrence depends on the Soviet's perception of our military strength relative to theirs, and on their perception of whether we have the National will to use that strength to defend ourselves and our allies and friends. One of the most dangerous courses of action that this country could take is to give the Soviets the perceptions that we are growing militarily weaker in the face of their continued build up, and that our National will is faltering because we face tough economic decisions. Deterrence would erode, and the risk of war would increase - at some point to a dangerously high level - with the increase in such Soviet perceptions.

2. My advice to the President has been, and will continue to be, related to the answer to the first question. The Soviet threat will not somehow diminish with the advent of the Gramm-Rudman-Hollings deficit reduction legislation. In fact, the net effect of holding the defense portion of the budget to zero growth in an attempt to meet the deficit reduction milestones of the legislation would be an increase in the threat relative to our capability to cope with it. This would most likely lead to the increased risk of war for the reasons stated above. Although we must be fically responsible, we simply cannot afford to base our defense budget primarily on internal economic considerations rather than on the growing Soviet threat

WHAT HAS BEEN ACCOMPLISHED BY THE REAGAN BUILDUP?

Question:

The initial Reagan defense buildup called for $1488 billion in budget authority over the five year period, which was $187 billion oer the last Carter request. The recent congressional activity completed this five-year period and the outcome is $179 billion below the President's targets.

1. Can you divide this reduction into inflation and other savings, and program reductions?
2. Can you identify the program reductions and elaborate on the impact of these reductions on force structure and military effectiveness.?

ANSWER:

The following table depicts the difference between the amounts initially requested and the amounts actually appropriated to the Department of Defense for FY 1982-1986:

($ in billions)

	FY 82	FY 83	FY 84	FY 85	FY 86	TOTAL FY82-86
March Amendment 1981	221.8	254.5	288.9	326.2	367.2	1,458.6
TOTAL ADJUSTMENTS since MARCH 1981	**-8.0**	**-15.0**	**-30.7**	**-39.4**	**-88.8**	**-181.9**
Current Approved TOPLINE	213.8	239.5	258.2	286.8	278.4	1,276.7

These total adjustments are estimated to break into the following distribution between program and inflation:

($ in billions)

	FY 82	FY 83	FY 84	FY 85	FY 86	TOTAL FY82-86
Program	-4.0	-2.5	-7.4	-7.6	-39.4	-60.9
Inflation	-4.0	-12.5	-23.3	-31.8	-49.4	-121.0
TOTAL	**-8.0**	**-15.0**	**-30.7**	**-39.4**	**-88.8**	**-181.9**

Illustrations of types of program reductions identified in the table above, by fiscal year are as follows:

FY 1982:

- MilPers changes to the Survivors Benefit Plan (SBP)
- R&D strategic program reductions delay studies evaluating Air Force Long Range Combat Aircraft alternatives. Tactical program reductions delay the development of anti-submarine warfare programs, Navy fighter aircraft improvements, and Air Force cargo aircraft.

WHAT HAS BEEN ACCOMPLISHED BY THE REAGAN BUILDUP?

ANSWER: 12 continued

FY 1983:

- MilPers pay raise halved from 8% to 4% and DoD directed to absorb 25% of cost. Inhibited efforts to achieve force structure, leaving shortfall of approximately 6,700 personnel.
- Major strategic programs reduced include 9 PEACEKEEPER missiles, 6 TRIDENT I missiles, 1 TRIDENT submarine, 110 Air Launched Cruise Missiles, and 91 tactical nuclear Pershing missiles. Also reduced were, 21 SH-60B (ASW helicopters), 86 HARM missiles, 3 F-15 aircraft, Battleship reactivation advance procurement, 24 MK-48 torpedoes, and 64 Mobile Protected Gun System vehicles.
- Reductions to Army force modernization, flying hours, depot and ship maintenance, fleet modernization and other readiness reductions causing ship deactivation and deferred air wing activation.
- A 13% reduction in R&D technology demonstration projects decreased ability to evaluate technical feasibility of advanced concepts before entering development. R&D strategic program reductions delayed the development options for the Army Ballistic Missile Defense program and the development of a secure basing mode for the MX ICBM.

FY 1984:

- Funds reduced for ADP leases without sufficient funds added to procure leased equipment. Industrial plant equipment reduced, impairing our ability to perform maintenance efficiently.
- Aircraft reductions include 5 AV-8B light attack aircraft for the Marines, 2 EP-3 intelligence collection aircraft, 6 SH-2F anti-submarine warfare helicopters, 2 C-2 cargo aircraft, 38 T-34C trainer aircraft, and 12 Air Force F-15 air superiority fighter aircraft.
- Missile reductions include 6 PEACEKEEPER ICBMs, 85 PATRIOT air defense missile systems, 25 PHOENIX air-to-air superiority missiles, 15 HARPOON and 1,218 MAVERICK air-to-surface missiles.
- Other reductions include a TAO fleet oiler, a MCM mine countermeasures ship, and 176 Army Light Armored Vehicles.
- R&D tactical program reductions to JSTARS, Air Force Fighter Derivative, Alternate Fighter Engine, and the 155mm Howitzer Improvement program delay the introduction of these more capable weapon systems.

WHAT HAS BEEN ACCOMPLISHED BY THE REAGAN BUILDUP?

ANSWER: 12 continued

FY 1985:

- Military pay raise reduced from proposed 5.5% to 4%.
- Disallowed O&M increases requested for unemployment compensation, Army wartime host nation support and flying hours, and the Air Force asset capitalization program.
- Reduced MX and PERSHING missile systems; 1 TAGOS surveillance ship; and 1 TACS crane ship.
- R&D strategic program reductions to the Small ICBM, B-1B bomber, TRIDENT, and ASAT programs, jeopardizing our ability to meet the technical requirements and schedules of the programs.
- Reductions to SDI affect our ability to investigate the
- full range of technologies needed for a defense against ballistic missiles.

FY 1986:

- Cut 10,730 active military end strength and the related pay and allowances. Will require a rephasing of planned manpower increases to man the expanding force structure, particularly for the Navy and Air Force. Cut 10,000 full-time reserve strength personnel for management, administration, and recruiting.
- Reduction of 36 PEACEKEEPER missiles, PERSHING missiles and cruise missiles delaying modernization of our strategic forces. Reduction of over 7,000 TOW missiles affecting anti-armor capability. Reductions to AGM-130, MAVERICK and HARM missiles affect air-to-ground munitions. Other significant reductions include 90 air-to-air AMRAAM missiles, 2 MCM mine countermeasures ships, 2 TR-1 aircraft for tactical reconnaissance, 117 rolling airframe missiles, 300 CHAPARRAL air defense missiles, and 19 T-34C trainer aircraft.
- R&D strategic program reductions increase the risk of maintaining PEACEKEEPER, TRIDENT II, and B-1B testing schedules and delay development of the Strategic Conventional Standoff Capability and SRAM II missiles. Tactical program reductions in modernization projects, Advanced Tactical Fighter Engine Model Derivative, C-17, electronic warfare, and Classified programs delay the availability of technologically superior weapon systems.

DEFENSE OUTLAYS

QUESTION:

The defense budget authority requested for FY 1987 is $34 billion more than the FY 1986 level, but the outlays rise only $16.4 billion. At the same time, unobligated balances at the beginning of FY 1987 are estimated to be slightly lower than the previous year. Finally, the large increases are in the fast spending accounts. All of this points to the fact that defense outlays may be understated.

1. Do you agree with the defense outlay estimate shown in the budget request?
2. Is it possible your outlay estimate is significantly understated?

ANSWER:

The Administration (DOD and OMB) made a rigorous joint review of all circumstances that impact defense spending in reaching the outlays estimates for the FY 1987 budget. These factors include historical estimates and actual data, rate trends, obligation and contract award patterns, procurement reform, program mix, the impact of Congressional action and P.L. 99-177, and the effects of reduced progress payments. After careful consideration of all these factors, the Department believes the estimates are reasonable and not significantly understated. It should also be recognized that the Congress, in establishing the Resolution, estimated outlays at a level very close to $274.3 billion.

On the Impact of Mergers of Defense Contractors

Senator Lautenberg: Please provide the Committee with a list of the mergers and acquisitions involving defense contractors about which your department has provided comments to the FTC or Department of Justice. Please provide the Committee with copies of those comments (including those related to the GE acquisition of RCA). Please describe those mergers or acquisitions that have proceeded despite Defense Department opposition or reservations.

Secretary Weinberger: The Justice Department and the FTC are normally under time constraints when they look at acquisitions and mergers. We therefore have come to rely on telephonic exchanges and meetings at various staff levels, rather than formal written requests and responses, to facilitate the process. As a consequence, we do not have records that would identify all such exchanges.

The normal role of the Department of Defense in this process is not to provide subjective views on the merger, but rather to provide factual information on current and past contracts with the corporations involved so that Justice or the FTC can assess the impact of the merger on the market. We have attempted to maintain a position of neutrality in these matters, and have identified no instance in which we have expressed formal opposition or reservations.

On the Impact of Mergers of Defense Contractors

Senator Lautenberg: Are there interests of the Defense Department and the public in maintaining and promoting competitive procurement and diversity of sources of products and services that are affected by mergers and acquisitions of defense contractors, but that are not adequately protected by the antitrust laws? Please explain. What steps are taken, or should be taken, to serve those interests?

Secretary Weinberger: When the process of a merger or acquisition involving major defense contractors is initiated, the Defense Department, apart from the potential antitrust considerations that are the responsibility of the FTC and Department of Justice, is necessarily concerned that its existing contracts and business interests are protected. Specific concerns include: potential for reevaluation of assets by the successor in interest; impact on DoD's contribution to pension funds; assurances that responsibilities and liabilities on existing contracts will be assumed by the successor; adequacy of resulting management structure; access to records; and the potential for increases in overhead costs. These areas are not provided for by the antitrust laws. The Department undertakes to protect these interests by means of novation agreements that recognize the successor to existing government contracts, and through advance agreements on costs.

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1987

TUESDAY, FEBRUARY 18, 1986

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:38 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Andrews, Symms, Grassley, Gorton, Chiles, Hollings, Johnston, Sasser, and Lautenberg.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and John Hilley, senior economist.

Chairman DOMENICI. The committee will come to order.

Good morning, Dr. Penner. We are pleased to have you appear once again before the committee to release the new CBO annual report.

OPENING STATEMENT OF CHAIRMAN DOMENICI

I would like to make a few comments before we get into your formal remarks, but first let me announce a change in our schedule. As the members know, we had Secretary of Treasury Baker scheduled to appear on February 7. The weather turned out to be somewhat treacherous and a number of members did not even come in and a number had scheduled to be out of town because the session had wound down in such a way that there was nothing on the agenda. At any rate, there were very few people here, and the Secretary, Senator Chiles and I agreed to postpone the hearing since we knew there was some interest in hearing the Secretary's views. So we rescheduled our hearing with Secretary Baker for this afternoon at 2 p.m.

To provide a reasonable time to eat, I am hoping that we can conclude our hearing with Dr. Penner no later than 12:30 p.m., if that is acceptable to everyone.

Now, Dr. Penner, once again, we welcome you. We appreciate your effort to provide the committee with a copy of your report in advance of the hearing today. And I am sure the report will prompt many questions.

IMPACT OF GRAMM-RUDMAN COURT DECISION

I would like to make a few opening observations about the role of this committee and the substance of your report, before we turn to your prepared remarks.

In the week or so that has passed since the district court ruling on Gramm-Rudman-Hollings many have speculated about the effect of the ruling on the budget process this year.

I can tell you that from the perspective of this Senator, the court's ruling does not weaken, but rather intensifies the pressure on our committee and on the Congress to reach a political consensus this year on the budget. As I am sure most members know, the district court ruled that on the very narrow issue of the trigger mechanism, the Comptroller General is considered an officer of the legislative branch for the purpose of Gramm-Rudman-Hollings by virtue of the fact that he is removable only by Congress and not by the President.

Actually, I am impressed that the court seemed to go out of its way to indicate that the broader concept of the across-the-board cuts laid out in the bill in no way represents an unconstitutional delegation of power. Indeed, the basic concept of the emergency law—fixed targets and a formula plan for reaching those targets in the absence of a political consensus—is still, as I see it, very much intact.

This means that if we cannot come up with our own plan here in Congress, and implement it, we will have to operate according to the backup procedures provided in the bill. Congress will have to vote directly up or down on the sequester cuts at the end of this calendar year in preparation for the October 1 fiscal year. We will not be able to lay the responsibility for the cuts on the Comptroller General or the President. Congress will have to make a visible and public choice to vote on the sequester cuts, which almost everyone believes is bad policy, or repudiate the bill that they passed just 8 months prior.

CBO REPORT MAKES DEFICIT PROBLEM APPEAR LESS URGENT

The only way out of this dilemma is to reach a consensus in the normal process and implement it before the sequester report does it for us. In that regard, the need to reach a political consensus now, Dr. Penner, I am not sure that the CBO report this year is going to be helpful. The very sharp decline in the CBO baseline deficits—and I would point out that the CBO report shows a declining deficit path for the first time since 1981—from my standpoint makes the problem appear less urgent. But when I look at the CBO baseline, it seems to me that we have almost assumed the deficit away. That is to say that these lower deficit numbers are due to changes in the approach that CBO is taking to defining the baseline.

For example, the CBO baseline for defense now assumes no real growth in the defense budget through the end of this decade. The CBO baseline, let me repeat, now assumes no real growth in the defense budget through the end of this decade. This is a dramatic change from the August 1985 CBO baseline, which assumed 5 percent real growth. Certainly some of the difference is due to congressional action. Congress cut back the 1986 appropriation bill and the Budget Resolution of last year assumed only 3 percent real growth in the outyears.

But the CBO baseline is almost $60 billion in outlays lower than the Budget Resolution that is in outlays over the 1986, 1987, 1988, 1989 period. The numbers are much larger if we look at spending authority or budget authority. Furthermore the CBO baseline makes no provision for the President's defense request. I am not now suggesting that it must. But everyone should know that when we discuss the baseline deficit there is no provision for the President's defense request.

DEFICIT WOULD REMAIN HIGH THROUGH 1991

We can choose to assume that defense spending will not grow in real terms for the rest of this decade. This is clearly not the assumption the President is making, and clearly, not the assumption from which they get a $38 billion deficit reduction requirement for the first year of Gramm-Rudman-Hollings. If we were to include the President's defense request in the baseline, the deficit would be about $195 billion for the next year and would remain over $150 billion through 1991.

That is what I understand the case to be and this is with CBO's very optimistic interest rate assumptions. If we go back to past practice of assuming high interest rates, consistent with current experience, then the budget deficits and the baseline, with the President's defense request, would not fall but would rise.

LOW INTEREST RATE PREDICTION A MYSTERY

On the matter of interest rates, Dr. Penner, I must tell you that the issue of what is reasonable to expect in the way of lower interest rates from deficit reduction, seems to me, is almost a mystery. Last year the committee passed a budget resolution that contained drastic policy actions that actually lowered the deficit below Gramm-Rudman-Hollings targets in the outyears, including the largest reconciliation instruction in history. At that time, the best we could get was no comment from the CBO on the effect of these actions on interest rates.

What I am talking about was the argument that we had in this committee about post-policy interest rates. We assumed that if that budget resolution with drastic cuts was in place, then we were entitled to some post-policy interest benefits. There was no comment from CBO.

Now, we have passed a law with targets and a procedure to get to these targets, which at best, is untried, and I note that CBO has decided to assume a sharply declining interest rate path.

I do hope that we will implement Gramm-Rudman-Hollings and that those interest rates will follow that path. But clearly it is all assumed in advance in the report that we have before us.

LOW INTEREST ASSESSMENT NOT HELPFUL

I can tell you that the criticism we received for being overly optimistic in the interest rate assumption last year did not help us in trying to get to a reasonable result last year. The low deficits that result from optimistic assessments of interest rates are not likely to help us reach a compromise this year, at least in my opinion.

Actually looking at page 64 of your report, I note that 90 percent of the $164.5 billion reduction in last August's baseline, from $284.6 to $120 for 1990, is due to assumptions about defense spending and interest rates. That is no real growth in defense and the optimistic interest rates are 90 percent of that reduction. The largest single legislative source of savings appears to come from this year's sequestration cuts.

The effect of the fiscal year 1986 sequestration was to reduce fiscal year 1987 spending by $16.3 billion with the outyear effect rising to $20.3 in 1990. That assumes that there would be absolutely no changes in any of those accounts.

I hope we can keep all these savings but I am not sure that that is an assumption that we can count on.

In fiscal year 1986, the sequestration cuts will reduce programs 4 to 5 percent, both defense and non-defense. The CBO baseline assumes, as I indicated a moment ago, that all of these are permanent and will remain for the next 5 years. Even the President's budget, incidentally, adds about $2 billion back to those sequestered programs because of high priority needs and the arbitrary nature of the cuts.

These add-backs are for popular and necessary programs like the FAA—which my good friend, Senator Andrews, is aware of—the Federal prison system, IRS agents, and the like.

I mention this only by way of an illustration. The point is that the baseline is no longer the sum of our wishes—fat target that is easy to cut. These baseline spending assumptions already embody much restraint, far more than we are accustomed in previous baselines, and maybe even more than we can stand if recent legislative action on spending is any guide.

Further, if we make reasonable small changes in the way we construct the assumptions in the baseline, we get a dramatically different deficit picture—that is rising rather than falling deficits.

I am concerned that if we do not look at these deficits critically we will assume that our job is nearly done or that it will be done for us in a rather easy fashion.

Gramm-Rudman is not intended to supercede the congressional budget process. It is intended to provide discipline from the outside for making the hard choices among programs.

This CBO baseline assumes that some of these choices are made in advance of the action. If we use the very low deficit numbers to avoid making legislative choices, we will find the problem much larger, and the options much fewer, when we come face to face with this summer's CBO/OMB midyear sequester report.

Senator Chiles?

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Thank you, Mr. Chairman.

Good morning, Dr. Penner, and welcome to the Budget Committee.

MUST LAY CARDS ON TABLE

After looking over the CBO annual report, you almost need sunglasses because of the glow. As the report points out, it is quite a reversal from last year's predictions. You know how much we rely on your estimates and this year, even more so, under the Gramm-Rudman-Hollings plan.

I certainly hope that your estimates prove out, but like anyone else on a diet, the Federal waistline does not get any smaller just because the scales are off to make us feel like we weigh a little less than we do.

Already we have had reports that the Pentagon has underestimated their outlays by about $15 billion. Now, we will be interested to have your findings, not just on that matter, but anywhere else in the budget where actual spending might exceed the administration estimates.

This year, of course, Congress is operating on a budget with a little uncertainty hanging over us. Gramm-Rudman-Hollings is under court challenge so we do not know with 100 percent certainty if the automatic sequester will be there, if things go wrong and it is needed.

But whether budget cuts are automatic, or whether we have to have the willpower to make them ourselves, the role of the Congressional Budget Office and the Office of Management and Budget are still vital to the process.

If we have the willpower, Congress will produce what is best for the country and include a set of sensible priorities and work on a budget with everything on the table. If we produce a resolution that does not meet the goals, including the Gramm-Rudman-Hollings deficit targets, then we certainly have a problem.

Even if the automatic sequester is finally thrown out on appeal, we would have to confront the fallback option; CBO and OMB would still make their recommendations; this committee would have to report out deficit cuts without amendment and take it to the floor for 2 hours of debate.

The option would be to take it or leave it. Whether we can do it in the budget resolution, under automatic sequester, or under the fallback, there is no way we can hide from that responsibility. So we look for guidance from you today. Your figures are encouraging, yet, I am, like the chairman, concerned that they could change just as dramatically by this time next year.

INTEREST RATES

I was delighted to hear the chairman's little talk on interest. I thought last year that all of our ranting and raving on this side had been in vain. We kept trying to talk about picking favorable interest rates on the basis that you had already accomplished something that no one had accomplished.

Now, it looks like the chairman has become a believer in that and he is concerned that you are picking interest rates that suggest we had already made the cuts all the way through that Gramm-Rudman-Hollings would require.

It is very good if we do it. But if not, as he has pointed out, interest rates will make an awful lot of difference. I hope that this means on the committee that we can get together and come up with what we think are reasonable projections for interest rates.

Senator Andrews [presiding]. Thank you, Lawton.

Dr. Penner, instead of an introductory remark, I just have three quick questions that I would like to ask you because I think that what we have got to find out from you, is where we are going with these figures?

DEFENSE OUTLAY ESTIMATE

Are you satisfied with the President's estimate for defense outlays?

Dr. **Penner**. There is a disagreement on that with regard to the budget authority that has been requested in the President's budget. We do believe that the particular pattern of expenditure in that area would lead to about $14.5 billion in outlays.

Senator **Andrews**. Is that what your number will be in your report later this month?

Dr. **Penner**. We will do our complete analysis of the President's budget, and will be releasing it a week from tomorrow. There could be minor changes in that, but we would not expect any major change.

Senator **Andrews**. Essentially, it will be in the area of $14 billion?

Dr. **Penner**. $14 billion to $15 billion, Senator.

RATE OF GNP

Senator **Andrews**. Dr. Penner, what assumption are you making about the growth rate for the economy?

Dr. **Penner**. We are forecasting 3.6 percent real growth fourth quarter over fourth quarter for 1986, and then slowing somewhat to 3 percent for 1987.

Senator **Andrews**. Have you run estimates on deficit outcomes at different rates of growth?

Dr. **Penner**. Yes; we have, sir. We have done that a number of different ways. In the——

Senator **Andrews**. Are all of those estimates in this book that you presented to us?

Dr. **Penner**. Yes, sir. It starts on about page 68 of our report.

Senator **Andrews**. I am aware of that. There are no other estimates that you have done, other than the ones that are in this present budget?

Dr. **Penner**. No; we have a high growth path; a low growth path; and then on page 72, we have what we call our rules of thumb.

Senator **Andrews**. But they are all in here?

Dr. **Penner**. Yes, sir.

REVENUE SHARING

Senator **Andrews**. Finally, what assumption are you making regarding general revenue sharing?

Are you assuming that it is going to be in, as the Congress has kept it in, in the past, in your estimates?

Or are you assuming that it is going to be out, as the President has requested?

Dr. **PENNER**. No; it is part of our baseline that it would be continued. It is our usual practice to have current law continued.

Senator **ANDREWS**. Thank you, Mr. Chairman.

Chairman **DOMENICI**. Thank you, Senator.

Senator Hollings, did you have a chance on opening and do you want to do that?

Senator **HOLLINGS**. Yes.

OPENING STATEMENT OF SENATOR HOLLINGS

TRUTH IN BUDGETING

I commend the chairman and ranking member in bringing this into focus. Dr. Penner, you have been a best friend of truth in budgeting but we could lose our best friend with these good assumptions that you have made. We have passed Gramm-Rudman-Hollings, but that is not to say that cuts have to be made at all. You can lower the deficit by increasing the revenues. You can increase spending. We did not pass anybody's budget in Gramm-Rudman-Hollings. We just said that when you pass your budget, whatever it may be, come this spring, by October 1, it had better have truth in budgeting. It had better provide the revenues to bring the deficit down to a particular level, otherwise, you are going to face the consequences—the budget is going to be cut for you.

So, I would hope that I like your projections, but let us not give any CBO authenticity early on the Gramm-Rudman-Hollings that it does not deserve. Because we have not really affected that discipline yet, and we are right into the dangerous straits, at this particular moment, trying to do exactly that.

And I appreciate your position, but we have not obtained these fine adjustments that would warrant the wonderful interest rates and growth rates and everything else that you project.

But I will get into that as we ask the questions.

I do thank you. Thank you, Mr. Chairman.

Chairman **DOMENICI**. Thank you, Senator.

Senator Lautenberg?

OPENING STATEMENT OF SENATOR LAUTENBERG

Senator **LAUTENBERG**. Thank you, Mr. Chairman. Welcome, Dr. Penner. I do not think that our faith in Dr. Penner has in any way been challenged. Because I believe, Dr. Penner, what you have done here, is to create a budget baseline by applying certain economic assumptions and then making certain arithematic projections of where we would be in the future.

You have not gone into the forecasting business, predicting changes in the basic structure with which we start.

Dr. **PENNER**. We now see the Balanced Budget Act as part of that inherent structure. We regard that as the law of the land, which established these binding targets, so we have assumed for the purposes of our economic forecasts that those targets will be met.

Senator **Lautenberg.** Mr. Chairman, I do not want to use my period for a short opening statement to get into questions, but I just wanted to make sure that I understood the ground rules that CBO have used.

MESSAGE BEING SENT CONGRESS

And I think that it is fair to say that CBO considers the effects of Gramm-Rudman-Hollings on interest rates, and other economic indicators looking out a few years, but does not apply the law to reduce the budget deficit.

Am I correct?

FACED WITH CONTRADICTION

Dr. **Penner.** Yes, sir. In doing this we were faced with two contradictory things. On the one hand, the Congress has passed a law which commits it to very specific deficit targets. On the other hand, you have the spending and tax laws in place today that lead to a result different than the targets.

We always, of course, project on the basis of current law, that is how we do our economics. So the question was, how should we define current law when we have these two contradictory things facing us? We chose to assume, in terms of our economic forecast, that the targets would be met. On the basis of that forecast, we computed what the spending and tax laws implied. For example, in 1987, the target is $144 billion, while the laws in place, given the economy that goes with those targets, would lead to $181 billion.

The advantage of doing it the way we have is that it tells you exactly how much those individual spending and tax laws have to be changed to reach the Balanced Budget Act's target of $144 billion. We do not then have to be concerned, as a lot of economists are concerned, that if you start with an economy based on the laws in place, and you ask how they have to be cut, you have to take into account all sorts of feedbacks and other things, so that it might be more or less than the $37 billion we mentioned.

With our procedure, you do not have to do that. All you have to do is to look at that $37 billion. That is what you have to cut to make this whole thing logically consistent.

Chairman **Domenici.** All right.

Let me see if I could describe it as I see it, Senator Lautenberg. In the past—let me give you an example—CBO would do its economic assumptions based upon what they call current policy. All right, so they come along and would assume, here is what the interest rates, the inflation rate and the deficit are going to be under current policy.

CBO would never change those assumptions regardless of what Congress proposed to do in cutting the deficit. So this committee was constantly having to go to the Congress and say, "Let us cut $80 billion." But then other Senators would say, "If we do, how will the economy improve?"

And CBO would say we cannot give you a post-policy estimate of the economics that go into a budget. So we were going around saying cut $80 billion and they would say what is the deficit going to be 3 years out?

And the deficit is still huge, because they would not change inflation, they would not change interest, they would not change unemployment as the new policy affected it.

What has happened now is very simple. So long as we understand it, we can live with it. What the CBO now says is here is current policy in terms of where the budget lines are, for purposes of determining how much you have to cut to get to Gramm-Rudman-Hollings. But low and behold, they have already predicted where you are going to be with the economic assumptions which they never would do before. On the basis that Gramm-Rudman-Hollings is the law of the land and therefore, current policy for baselines.

And as long as we understand that, that is fine.

The other big point that we must understand is that the President says that we need $38 billion in outlay cuts to get to $144 billion. Dr. Penner will say that is about right. However, this report assumes no growth in defense. The President assumes almost 9 percent growth in defense. And yet, if we are not careful, the number that you must reach to get to $144 billion is the same for both. So you cannot——

Senator **Lautenberg**. That is almost a coincidence, though.

Chairman **Domenici**. Well, it cannot be that. I mean we all must understand that if we are going to increase defense any over the next 5 years what must be done. The CBO has a flat line—no growth—then the $38 billion of the President is changed dramatically and the $37 billion that he is giving us is changed dramatically in terms of how many cuts you have got to make.

We all must understand that. And so it should be understood by those who are reporting that the job is not very tough. All right, it looks to me like we are about $15 billion in outlays apart, if the President's defense number is assumed. It looks like instead of $38 billion, we have got to get $48 billion, more like $53 billion. Now, if we do not care to increase defense, we are in the ballpark, between $35 and $40 billion.

Senator **Lautenberg**. Mr. Chairman, I am sorry, I do not want to debate this and hold up the wheels of progress, but I think it is important that all of us understand exactly where we are.

And the fact that CBO has ignored, if I may use that word, the President's request on defense partly explains CBO's baseline. But there are also distinct differences in assumptions of interest rates, and growth and unemployment, based on the effects of Gramm-Rudman-Hollings.

Am I correct, Dr. Penner?

Dr. **Penner**. That is correct.

Chairman **Domenici**. It is all salutary, I understand.

Senator **Lautenberg**. So, here we have several things. Senator Hollings this is not the traditional second opinion that you get when you go to the doctor's office. We are looking almost at two different diseases at the same time. And one guy is saying, well you have got a problem with your heart, and the other guy is saying, the diet is the principal problem and I do not think that the heart matters.

So on different wavelengths.

Senator **Hollings**. Dr. Penner, we appreciate you giving us this hearing.

Chairman **Domenici**. We have a statement from Senator Hatch, who is unable to be here this morning, that we will insert in the record at this point.

Statement of Senator Hatch

Thank you for joining us today Mr. Penner. Your comments before the Senate Budget Committee regarding the Congressional Budget Office's economic and budget projections for fiscal years 1987 through 1991 are welcome and useful to members of Congress who seek to pass a budget which balances the interest of states and localities while eyeing the red ink of an unbalanced budget.

Gramm-Rudman-Hollings has introduced a new dimension to the budget process, shifting power to the President in an effort to clamp the unchecked growth in federal spending. Finally, Congress has recognized that our nation cannot tolerate a developing trend of annual deficits exceeding $200 billion without severe economic repercussions. While Gramm-Rudman-Hollings is not flawless, I hope Congress will adhere to the maximum deficit targets established under Gramm-Rudman-Hollings. The President's FY87 Budget should be used as a guide by Congress since it subscribes to deficit spending not exceeding $144 billion in fiscal 1987.

Gramm-Rudman-Hollings is marred in several ways. One provision requires defense programs to share 50-50 with non-defense programs in the across-the-board cuts, yet defense spending accounts for only 28 percent of all federal spending. Another provision permits Congress to circumvent the FY86 deficit-reduction target it set for itself by limiting the first round cuts to $11.7 billion. A far cry short of the estimated $38 billion cut required to meet the FY86 deficit-reduction target of $172 billion. I remain skeptical about achieving a balanced budget by 1991 under Gramm-Rudman-Hollings simply because of congressional history.

The Congressional Budget & Impoundment Act of 1974 purported to establish order in the budget process, setting budget deadlines and creating rules by which Congress would abide. Since no enforcement mechanism truly exists, Congress has been delinquent in meeting these budget deadlines and adhering to its own rules. I would not be surprised if cuts under Gramm-Rudman-Hollings are not mitigated before the second round of cuts scheduled for October 1986.

A review of actual spending versus spending targets assumed in congressional budget resolutions of the past five fiscal years reveals that Congress exceeded its own budget resolution by an average of $28 billion a year. For the current fiscal year, the CBO Scorekeeping Report paints a similar picture with actual outlays surpassing by $19 billion the level of outlays assumed in the First Concurrent Budget Resolution for FY86. Congress is $19 billion over in outlays and we are only in the fifth month the fiscal year!

Regardless of the difference between CBO numbers and the President's FY87 numbers, the differences are minute relative to deficits in excess of $200 billion; differences of $2–$10–$20 billion are pocket change to a federal budget approaching annual outlays near $1 trillion. Despite this being an election year, I hope Congress will find the will to produce a budget which weighs spending for a multitude of special programs against the larger backdrop of the prospect of a nation possibly headed for economic troubles.

Chairman **Domenici**. Now, we are going to proceed.

Will you please start your testimony and your entire statement will be made a part of the record.

And you give us your own version of it, but it will be incorporated into the record.

Please proceed.

Dr. **Penner**. Thank you, Mr. Chairman.

STATEMENT OF DR. RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. **Penner**. It is a pleasure to appear before this committee to discuss our annual report and the economic and budget outlook.

OUTLOOK OPTIMISTIC

The report was released this morning. As has been said, our economic outlook is quite optimistic. We expect fourth-quarter-to-fourth-quarter real economic growth, as I have said before, to accelerate from 1985's 2.5 percent to 3.6 percent in 1986, slowing slightly to 3 percent during 1987. Inflation accelerates very slightly as well, from 3.2 percent in 1985 to 3.9 percent in 1986, and to 4.1 percent in 1987. Short-term interest rates decline somewhat in 1986 and remain roughly stable in 1987.

REASONS FOR OPTIMISM

Our optimism is based on a number of factors. The most important of them are declining interest rates and a soaring stock market, which should encourage consumer spending and business investment. Other factors are a falling exchange rate, which should, with time, halt the deterioration of the trade balance, and falling prices, which should add to our real income and counter the inflationary impact of the falling exchange rate.

As always, there are risks to the outlook. On the good side, our projection of falling oil prices uses a somewhat higher price than prevailing today. On the other side, the credit situation is still worrisome; thrift institutions are still failing; the farm credit situation is precarious; the LDC debt is still a major problem; and falling oil prices, while good for the economy on balance, are not good for those holding energy-based loans, and of course, for domestic oil producers.

In addition, our forecast for business investment is more optimistic than is supported by recent surveys of investment plans. We count on the latter moving up quickly in the near future.

Given our forecasts and economic projections, the baseline budget situation has improved markedly since we last reported in August 1985. It is, Mr. Chairman, as you noted, the first time in a number of years that we have projected declining absolute deficits, even though they still remain very high relative to most of our fiscal history. Our latest estimates show a deficit of $208 billion in 1986, declining to $181 billion in 1987 and then to $104 billion by 1991.

This improvement has led many to think that it will not be as difficult to achieve the targets of the Balanced Budget Act as was thought as recently as a month ago, when I last appeared before this committee. I, myself, was surprised by how the projected deficit for 1987 turned out.

BASELINES DIFFERENT FROM THE PAST

However, as has been noted here a number of times, an important word of warning is in order. As you suggested, Mr. Chairman, and I think it bears repeating by me to give it more emphasis, the baseline projected in this report is different in several respects from baselines projected in the past. It is truly a barebones baseline. First, it already reflects the effects of the 1986 sequestration. In other words, it has already been cut once.

DEFINING DEFENSE BASELINE

Second, we have changed our approach to projecting the defense baseline as you noted. Now, defining the defense baseline has always raised a number of conceptual issues. Procurement tends to be lumpy because we plan on the purchase of major weapons over a number of years, even though funds are often appropriated for them annually. In recent years we have, therefore, used the defense budget authority in the most recently passed budget resolution to provide our definition of current policy in defense. We did not believe, however, that that was appropriate this year.

The Balanced Budget Act made the deficit targets in the 1986 resolution obsolete. After 1986 appropriations actions and the subsequent sequestration, budget authority for defense came out significantly below the target established by the resolution.

Without the resolution for guidance, we just decided to project defense budget authority at a constant real level, the same approach taken for most nondefense discretionary programs.

But clearly, without any room for any real growth in defense, this baseline becomes harder to cut than those of the past.

ESTIMATING INTEREST RATES

With regard to interest rates and your comments on them, Mr. Chairman, I think it important to note that what we were asked for before is really very different from what appears in our most recent projections. At other times, we have been asked for a precise estimate of the economic effects of shifting from one set of policies to another.

Now, the economics profession is in disarray on this issue, and a wide array of estimates could be obtained from highly respectable economists. For CBO to pick one set of estimates out of the array and to use them to compare, say, the House budget resolution with the Senate budget resolution, would be very dubious scientifically and, I think, mischievious politically.

That is why I suggested before that CBO provide ranges of these things such as can be found in the literature, and see if we can reach bipartisan agreement as to what is reasonable within the range of estimates.

When we project the longer run budget, and the longer run economy, we rely very heavily on historical experience in the postwar period. We are careful to say that those projections are not necessarily consistent with the policies that are assumed. Indeed, right away, you see the process has an illogical element in that we base real growth on average historical experience, when the policies are not average. Nevertheless, this approach has served us very well in the past, perhaps by luck, because in fact this particular expansion has been extraordinarily average in its characteristics.

We departed from the historical average in interest rates in earlier periods because our baseline always showed very rapidly rising deficits. Clearly, it would seem absurd to think that rising deficits were consistent with constant real rates.

Indeed, 2 years ago, when the deficit was soaring, I testified here that those longrun projections, not only were necessarily consistent with the policies, they were very likely to be inconsistent since it was very hard to historically experience with soaring deficit.

But the 1984 downpayment on the deficit we had was more important than generally perceived, and after that things added up more satisfactorily than previously. And then, with the more dramatic improvement in the baseline by the end of 1985, because of the congressional actions, the 1986 sequestration and the legal commitment to a balanced budget, we thought it reasonable to assume that real interest rates would move down to their historical levels in the long run.

RATE DECLINE NOT PRECISE ESTIMATE

In fact, the end point of the projection is about equal to average real interest rates over the last 30 years. I must admit that is arbitrary. I certainly do not want anybody to think that the 30 to 40 basis point fall per year in real short-term interest rates is a scientifically precise estimate of either the Balanced Budget Act's declining deficit targets or of the declining baseline deficits. It is much cruder than that, it simply reflects what the world would look like if we gradually returned to the kind of real interest rates that we are more acquainted with historically.

I gather we are being criticized here for taking as current policy the targets in the Deficit Reduction Act. But we really felt that we had no other choice but to assume those targets were the law of the land. The law, was passed by the entire Congress; it was signed by the President.

That, then, was our approach to the whole thing. I guess I should point out also, in terms of the very large interest savings that you mention, only a small part of those are due to the change in the way we project interest rates in the long run. The bulk of the interest savings are due to deficit reduction actions in other areas and to the fact that we were a bit too pessimistic about interest rates last year and so had to move down the whole starting point by about a half a point. I think, by the way, that it was a pretty good interest rate forecast, but nevertheless it was a bit too pessimistic. So those other things play a very important role in the interest rate savings that you see reported in our table.

As you have very clearly pointed out, sir, the new baseline does make things look easier they really are. And indeed, the nature of the challenge ahead is illustrated by certain other numbers.

CBO SEQUESTER REPORT

If there were no legislative actions between now and next August, and if our forecasts and technical assumptions were to remain constant, our sequestration report would show that an automatic outlay cut would be $37 billion compared with our baseline, an amount sufficient to bring 1987 outlays to $989 billion. That is almost exactly equal to the outlays estimated for 1986, after the first sequestration.

In other words, all the COLA's; all the rises in caseloads; any inflation adjustments you made anywhere in the budget—all these would have to be offset somehow by cuts.

Chairman DOMENICI. Or another way to say it, Dr. Penner, is that you would have a no-growth defense budget from which you would have to, under the Gramm-Rudman-Hollings automatic sequester, find another $18.5 billion reduction.

Dr. PENNER. Yes; I think it is even worse than that in that the Gramm-Rudman-Hollings law tells us that if nothing has been done in defense, if there are no appropriations, we go right back to the 1986 nominal level. I think it leads to the same result that you are suggesting, but there is no room—our Gramm-Rudman-Hollings baseline is lower than the CBO baseline because it allows for no real growth whatsoever, if, indeed, nothing has been done.

Chairman DOMENICI. Of the postsequester number, you would take half of $37 billion.

Dr. PENNER. To put it a different way, new budget authority would be limited to $271 billion in defense or $30 billion below the CBO baseline and $49 billion below the President's request. That would dramatically change the whole nature of the defense effort. Senator Chiles pointed to the uncertainty in these kinds of numbers, and I would certainly add emphasis to that. The numbers that I am giving you now are only illustrative of what may appear in our August report.

First and most obvious, I am relying on CBO estimates here. Our calculations will be averaged with OMB's for that report.

Second, legislation and changes in our forecast or technical assumptions can radically change the amount of a required sequestration. Because across-the-board cuts apply to only a bit more than a quarter of the total budget, estimating errors are magnified when the percentages of across-the-board cuts are calculated. For example, a 1-percent error in estimating outlays, or $10 billion, converts into a 4.5-percentage point change in the automatic cuts applied in the nondefense area.

In conclusion, Mr. Chairman, I think we have made considerable progress against the deficit in recent years, but much remains to be done in order to ease the burden on future generations. Our estimates suggest that the task ahead will be difficult but the commitment to lower deficits is stronger than ever before, and that is an important reason that we feel that we can project a fairly optimistic economic outlook.

Thank you, very much.

Chairman DOMENICI. Thank you, Dr. Penner.

[The prepared statement of Dr. Penner follows:]

Statement of
Rudolph G. Penner
Director
Congressional Budget Office

Mr. Chairman, it is a pleasure to appear before this Committee to discuss the CBO economic and budget projections. These projections are described in detail in the CBO report entitled The Economic and Budget Outlook: Fiscal Years 1987-1991, which I am releasing today. In my testimony this morning, I will touch on:

- The economic forecast for 1986 and 1987 and projections for 1988-1991; and
- The CBO baseline budget projection, and how it compares with the CBO projection made last August and with the deficit targets of the Balanced Budget and Emergency Deficit Control Act of 1985.

I will conclude with an illustrative calculation of the effects of alternative economic assumptions on the baseline budget estimates.

CBO'S ECONOMIC AND BUDGET PROJECTIONS

The outlook for reducing budget deficits has improved dramatically since last summer, and financial markets have responded with a sharp rally. Although overall economic activity has not yet reacted to these improved financial conditions, the Congressional Budget Office (CBO) expects economic growth to pick up this year.

In 1985, the economy grew at a comparatively low rate of 2.3 percent, well below the substantial gains in the first two calendar years of the current expansion. Growth in productivity came to a halt as employment continued to grow rapidly. The unemployment rate edged down during 1985 and, despite three full years of recovery, the inflation rate remained almost unchanged from the moderate rates attained after the last recession.

Most forecasters, including CBO, anticipate that growth in real gross national product (GNP) will be somewhat faster this year--at about 3½ percent--than it was in 1985. The tremendous rally in financial markets during the second half of 1985 and the sharp decline in the dollar have enhanced the prospects for a pickup in economic activity in 1986. The rise in stock prices and the decline in interest rates will encourage consumer spending and business capital spending, while the decline in the dollar should halt the deterioration in the trade sector. If lower oil prices are sustained, the sharp drop in prices early this year will contribute to growth in economic activity and restrain inflation.

The improvement in financial conditions and the decline in the dollar last year were, at least partially, the result of the dramatic change in the outlook for reducing future budget deficits. The implementation of the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177), together with earlier Congressional action, will reverse the recent trend of rising budget deficits. Although a federal district court recently ruled that certain aspects of the Balanced Budget Act are unconstitutional, the deficit targets established by the act still remain in effect. These targets would lower projected deficits from about $208 billion in the current fiscal year to $144 billion in fiscal year 1987, with annual reductions of $36 billion thereafter. The decline in the structural deficit from fiscal year

1986 to 1987 would be about 1.5 percent of potential GNP, the third largest such reduction in fiscal stimulus since the mid-1950s. By itself, such an abrupt shift in fiscal posture could temporarily slow the economic expansion in 1987. But several other factors--including the decline in the dollar, lower interest rates, and the fall in oil prices--are expected to counteract the contractionary effects of the budget shift.

CBO's new baseline budget estimates show much smaller deficits in the 1987-1990 period than the baseline projection of last summer (see Table 1). While the policies of last year's budget resolution were not fully carried out, Congressional action to date has significantly lowered projected defense and nondefense spending. The projected decline in budget deficits under the policy assumptions of the baseline occurs because revenues are projected to grow in response to both inflation and growth in real incomes. At the same time, outlays are projected to grow only slightly faster than the rate of inflation (see Figure 1). The baseline assumes no real growth in defense and nondefense appropriations above a base already cut by the 1986 sequestration called for in the Balanced Budget Act. The additional action needed to comply with the deficit targets amounts to about $37 billion in fiscal year 1987, or $354 billion over the 1987-1991 period.

The sharp decline in long-term interest rates in 1985 seemed to reflect a market expectation of less Treasury borrowing in future years. Sectors of the economy that are interest-sensitive, such as residential construction, already show signs of increased strength. But the major benefit of reduced

TABLE 1. BASELINE BUDGET PROJECTIONS, DEFICIT TARGETS, AND UNDERLYING ECONOMIC ASSUMPTIONS

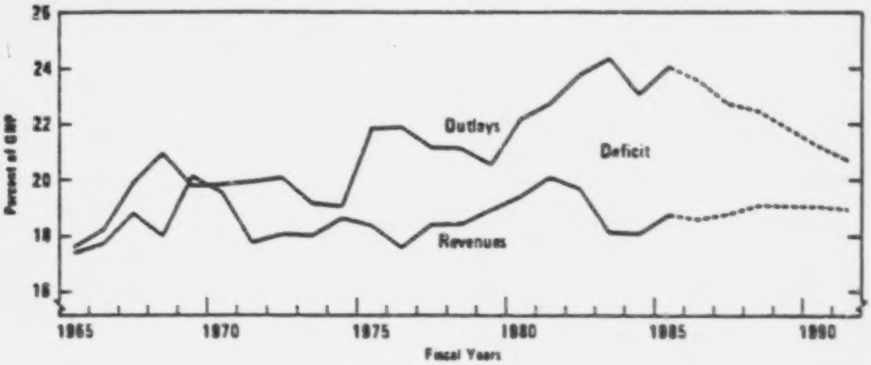
	Actual 1985	1986	1987	1988	1989	1990	1991
Budget Projections (By fiscal year, in billions of dollars)							
Baseline Estimates							
Revenues	734	778	844	921	991	1,068	1,144
Outlays	946	986	1,025	1,086	1,135	1,188	1,248
Deficit	212	208	181	165	144	120	104
Deficit Targets	N.A.	a/	144	108	72	36	0
Baseline Less Targets	N.A.	a/	37	57	72	84	104
Economic Assumptions (By calendar year)							
Nominal GNP, percent change	5.8	6.9	7.3	7.6	7.8	7.8	7.5
Real GNP, percent change	2.3	3.2	3.1	3.3	3.5	3.5	3.2
CPI-W, percent change	3.5	3.4	4.2	4.4	4.4	4.3	4.3
Civilian Unemployment Rate	7.2	6.7	6.7	6.5	6.3	6.1	6.0
Three-Month Treasury Bill Rate	7.5	6.8	6.7	6.4	6.1	5.7	5.4

SOURCE: Congressional Budget Office
NOTE: N.A. = not applicable.

a. The Balanced Budget Act set a target of $171.9 billion in fiscal year 1986, but limited the sequestration to $11.7 billion. CBO's fiscal 1986 baseline deficit estimate includes the $11.7 billion sequestration, and therefore the $208.3 billion deficit for that year fulfills the act's requirement.

Figure 1.

Baseline Revenues and Outlays



SOURCES: Congressional Budget Office, Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis.

budget deficits will come, it is generally agreed, in their long-run effects on living standards. Other things being equal, lower deficits should reduce real interest rates and foreign capital inflows, thereby encouraging increased domestic capital formation and reduced foreign indebtedness.

THE ECONOMIC OUTLOOK

The slowing of economic growth in 1985 was largely the result of a reduction in inventory investment. Growth in real final sales was down only slightly from 4.5 percent in 1984 to 4.0 percent in 1985, as weaker household and business spending was partially offset by strengthened government defense purchases and slower deterioration of the trade sector.

At year-end, most indicators began to reflect improving economic conditions. A major exception was net exports, which in December showed sharp further deterioration. But housing starts, retail sales, durable goods orders, employment, capacity utilization, and the overall index of leading indicators all rose sharply. The rally in the stock and bond markets, the decline in the dollar, and the growth of employment are likely to provide a boost to demand in 1986. Moreover, inventories were quite lean at year-end, except for autos, so that increased strength in final sales is likely to be quickly translated into output.

Another development that could have very favorable effects on both inflation and economic growth in the forecast period is the recent drop in oil prices. The CBO forecast was completed in December, before the recent sharp declines. Some decline was assumed in the forecast. By early February, however, short-term futures prices for crude oil were in the $15 to $19 range per barrel--about $6 below the refiners' acquisition cost assumed in CBO's economic projection for mid-1986. Oil prices have been very volatile, however, and some of the decline could be reversed if oil producers agree on a new distribution of output quotas.

The Forecast for 1986 and 1987

The first two years of CBO's baseline economic projections are a "conditional" forecast based on specific policy assumptions:

- The Balanced Budget Act of 1985 is assumed to be fully implemented. The budget deficit is $208.3 billion in fiscal year 1986, well above the $171.9 billion target because the automatic spending cut is limited to $11.7 billion this year. For fiscal year 1987, the forecast assumes that the $144 billion deficit target will be attained.
- The preliminary target ranges for the levels of the narrower monetary aggregates announced last July are assumed to be adjusted somewhat to reflect actual experience through late 1985.

In addition, dollar exchange rates are assumed to decline this year, though less rapidly than in the second half of 1985. Oil prices are assumed to decline about 18 percent from the last quarter of 1985 to mid-1986, and food prices are assumed to rise less than the general price level.

Given these assumptions, CBO expects inflation-adjusted GNP to grow 3.6 percent in 1986 and 3.0 percent in 1987 on a fourth-quarter-to-fourth-quarter basis (see Table 2). The unemployment rate is projected to remain steady at 6.7 percent through calendar year 1987. Inflation is expected to rise gradually in the forecast period. The three-month Treasury bill rate is expected to decline from 7.5 percent in 1985 to 6.7 percent in 1987.

Medium-Term Economic Projections

The projections for 1988-1991 are not a forecast of economic conditions, but assumptions based on average historical experience. Specifically, the growth rate for real GNP from the fourth quarter of 1982 to the fourth

TABLE 2. THE CBO FORECAST (Fourth-quarter-to-fourth-quarter growth rates)

	Actual		Projected	
	1984	1985	1986	1987
Nominal GNP	9.0	5.8	7.6	7.2
Real GNP	4.7	2.5	3.6	3.0
GNP Implicit Price Deflator	4.1	3.2	3.9	4.1
CPI-W	3.6	3.2	3.5	4.5

quarter of 1991 is assumed to equal the average growth rate in the nine-year periods following earlier postwar recessions. These outyear economic assumptions are not predicated on specific budget policies, and may not be consistent with the budget policies now in place. The major characteristics of the 1988-1991 projections are shown in Figure 2.

- Real GNP grows moderately at an average rate of approximately 3.4 percent.

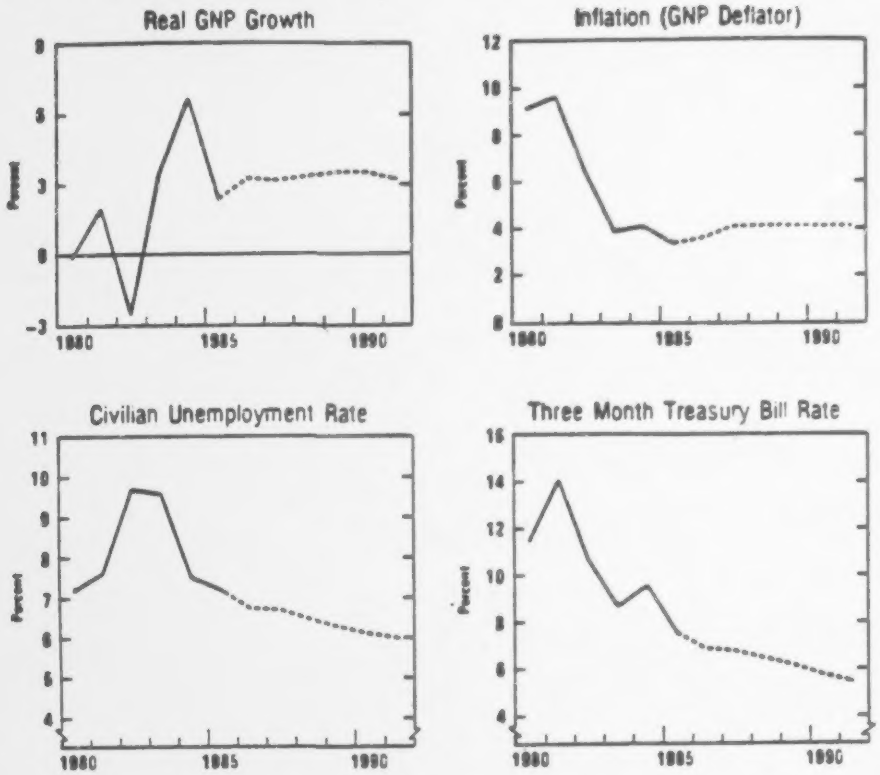
- The unemployment rate declines gradually to 6.0 percent by 1991. oInflation, measured by the CPI-W, holds at about 4.3 percent over the projection period.

- Interest rates decline in the outyear projection. The three-month Treasury bill rate, for example, declines from 6.7 percent in 1987 to 5.4 percent in 1991.

Uncertainty in the Outlook

The performance of the economy could easily turn out to be much better or worse than CBO projects. The major uncertainties in the near term are

Figure 2.
Major Economic Assumptions



SOURCES Congressional Budget Office U.S. Department of Commerce Bureau of Economic Analysis U.S. Department of Labor Bureau of Labor Statistics Federal Reserve Board

related to oil prices, the trade sector, financial conditions, and federal fiscal policy. Should oil prices remain low, inflation could be significantly lower and real output higher than projected by CBO. The recent decline in interest rates has greatly improved the financial status of many financial institutions and reduced the debt-service costs of developing countries. But some countries will be made worse off by the drop in oil prices and some financial institutions still suffer from poor-quality loans. For this reason, a financial crisis that would significantly raise risk premiums and interest costs cannot be ruled out.

Both the future course of the dollar and the response of net exports to the dollar's recent fall are difficult to predict. Some forecasters believe that foreign exporters will try to maintain their market shares by reducing profit margins rather than raising prices, thereby causing a delay in the response of U.S. imports to the depreciation of the dollar. Finally, the Balanced Budget Act may not be fully implemented, especially if constitutional challenges to the act are successful. Moreover, exactly how the deficit targets will be met is unclear. These uncertainties make it difficult to predict the short-run economic consequences of the projected turnaround in fiscal policy.

THE BUDGET OUTLOOK

Under CBO's baseline assumptions, which include no real growth in defense or nondefense appropriations, the total federal deficit would fall from $208 billion in 1986 to $181 billion in 1987 and $104 billion in 1991 (see Table 1). The projected decline in baseline deficits parallels the deficit targets in the 1986 budget resolution, but falls increasingly short of the deficit targets in the Balanced Budget Act, which contemplates a zero deficit in 1991.

Over the next five years, revenues are projected to grow on average by 8 percent per year, slightly faster than the assumed average growth of the economy. On the other hand, outlays are projected to rise by an average of 4.8 percent per year, only slightly higher than the assumed rate of inflation. As a result, revenues would remain roughly constant as a percent of GNP, but federal outlays and the deficit would fall, as shown in Figure 1.

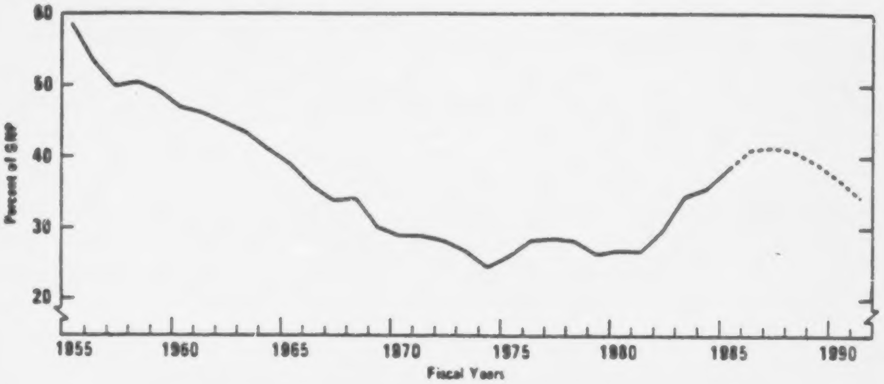
The projected decline in budget deficits would slow the growth of federal debt and reduce the government's share of total credit demand. Under CBO's baseline assumptions, publicly held federal debt is projected to grow from $1.7 trillion by the end of 1986 to $2.4 trillion by the end of 1991. In relation to GNP, debt held by the public would grow from 41.0 percent in 1986 to a peak of 42.7 percent in 1988 and then decline to 40.2 percent by the end of 1991. Of course, the decline in the debt-to-GNP ratio would be sharper if the Balanced Budget Act is implemented (see Figure 3).

Changes in Baseline Projections

The budget outlook under baseline assumptions has changed dramatically from a year ago. In its 1985 annual report, and again in its update report

Figure 3.

Federal Debt Held by the Public



SOURCES Congressional Budget Office, Office of Management and Budget, U.S Department of Commerce Bureau of Economic Analysis

NOTE The values shown for the 1986 1991 fiscal years are based on the assumption that the deficit targets of the Balanced Budget Act will be met

last August, CBO projected that baseline deficits would rise from slightly more than $200 billion in 1985 to almost $300 billion by 1990. The basic change in the deficit outlook in this report has resulted from lower projections for spending, primarily for defense and nondefense discretionary programs and for net interest costs (see Table 3).

CBO's baseline projections of last year assumed that defense appropriations would increase as specified in the 1985 budget resolution (and extended to 1990), at an average rate of 5½ percent in real terms--after adjustments for projected inflation. The 1986 budget resolution specified

TABLE 3. CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE AUGUST 1985 (By fiscal year, in billions of dollars)

Major Changes	1986	1987	1988	1989	1990
August 1985 Baseline Deficit	212	229	243	264	285
Major Changes:					
Lower defense outlays	-9	-26	-48	-71	-96
Lower nondefense discretionary program outlays	-10	-19	-20	-21	-22
Lower net interest costs	a/	-7	-16	-31	-51
Other outlay changes	6	-4	-4	-8	-12
Lower revenues	9	9	10	11	16
Total changes	-4	-48	-78	-120	-165
February 1986 Baseline Deficit	208	181	165	144	120

SOURCE: Congressional Budget Office.

a. Less than $500 million.

zero real growth for defense appropriations in 1986 and 3 percent real growth thereafter. Actual 1986 defense appropriations, however, fell short of the budget resolution target, and the 1986 sequestration will reduce the amount of new budget authority even further, to below the 1985 level. CBO's latest baseline projections assume zero real growth in defense appropriations from the 1986 postsequestration level. Because the Balanced Budget Act lowered the outyear deficit targets contained in the 1986 budget resolution, the assumptions of the resolution can no longer be taken as necessarily representing current Congressional policy. The combination of these factors reduces projected defense outlays by $250 billion for 1986 through 1990 compared with CBO's baseline projections of last August.

Even with 3 percent real growth in defense appropriations in 1987 and beyond, baseline deficits would decline over the next five years, although not as sharply. Instead of baseline deficits declining from $208 billion in 1986 to $104 billion in 1991, they would decline to $150 billion.

The latest baseline projections for nondefense discretionary programs are also lower than those made last year, reflecting reductions made in 1986 appropriations and the effects of the 1986 sequestration. The reduction from CBO's baseline projections of last August is almost $92 billion for the five-year period 1986-1990.

CBO's latest short-term forecast and long-run economic assumptions also feature lower interest rates than were assumed last year. These lower rates, together with a reduction in debt service costs because of other changes, reduce net interest outlays by over $100 billion for 1986-1990 compared with last August's baseline projections. Relatively small changes in baseline deficits result from revised projections for farm price supports and Medicare and other entitlement programs, and from slightly lower projected revenues.

Trends in Federal Spending

Baseline outlays are projected to grow by $262 billion, or 4.8 percent annually, over the 1986-1991 period. Relative to the size of the economy, however, both total spending and all its major components decline. Total outlays fall from 23.5 percent of GNP in 1986 to 20.6 percent of GNP in 1991 (see Table 4). The trends in federal spending are illustrated in Figure 4.

Because the CBO baseline projections assume no real growth in defense budget authority over the 1986 program level, the defense share of GNP hits a maximum of 6.4 percent in 1985 and 1986 and then drops. By 1991, under baseline assumptions, the ratio of defense to GNP would be 5.7 percent--less than in fiscal year 1982.

Spending for entitlement and other mandatory programs is projected to decline from 10.8 percent of GNP in 1986 to 10.0 percent by 1991--about the level of the late 1970s. Nondefense discretionary spending, which already has declined to about the same share of GNP as it represented in 1962, falls further throughout the projections period to 3.4 percent of GNP in 1991.

Because of declining deficits and interest rates (which are predicated on reaching the deficit targets in the Balanced Budget Act), net interest declines from its 1985-1986 peak of 3.3 percent of GNP to 2.7 percent in 1991.

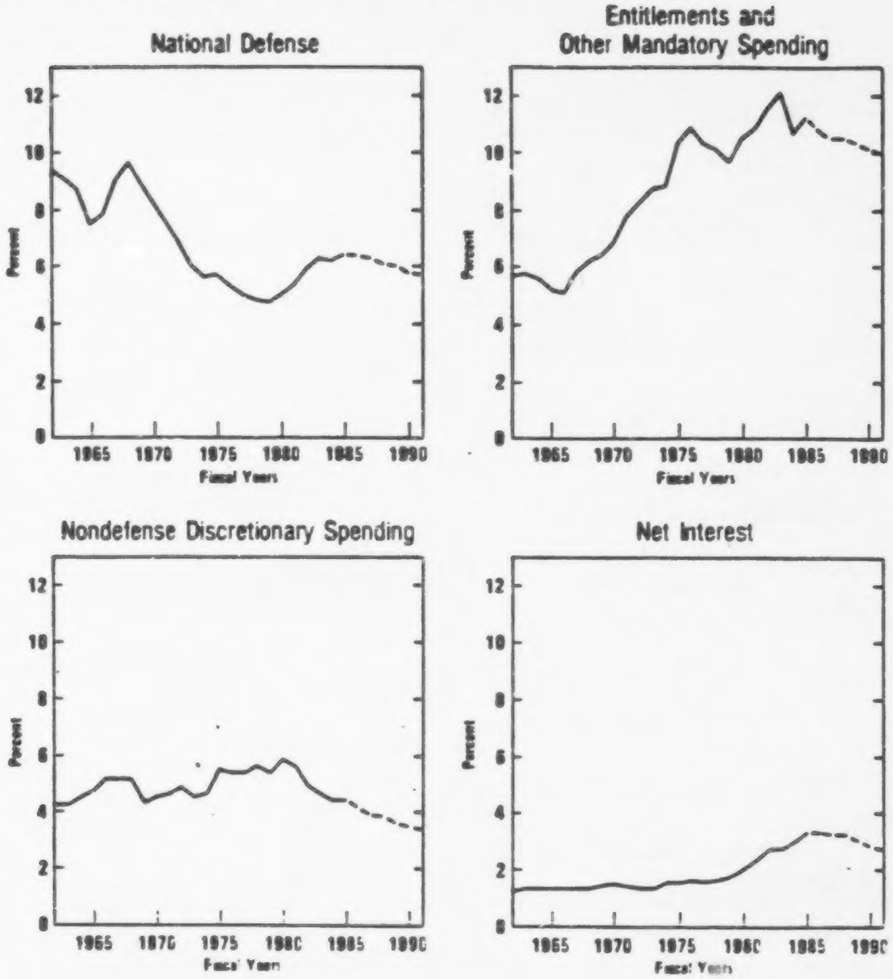
TABLE 4. CBO BASELINE BUDGET PROJECTIONS (By fiscal year)

	1986	1987	1988	1989	1990	1991
			In Billions of Dollars			
National Defense	269.5	284.0	296.4	310.9	326.9	343.9
Entitlements and Other Mandatory Spending	453.7	473.6	509.0	536.4	566.5	604.1
Nondefense Discretionary Spending	173.2	174.3	182.6	188.3	195.9	204.0
Net Interest	138.6	145.0	154.4	157.6	159.1	160.3
Offsetting Receipts	-48.8	-51.5	-56.4	-58.4	-60.7	-64.4
Total Outlays	986.1	1025.3	1085.9	1134.9	1187.6	1247.9
Revenues	777.8	844.0	921.0	991.3	1067.5	1143.6
Total Deficit	208.3	181.3	164.9	143.6	120.1	104.3
Debt Held by the Public	1720.1	1900.4	2064.4	2206.9	2326.1	2429.4
			As A Percent of GNP			
National Defense	6.4	6.3	6.1	6.0	5.8	5.7
Entitlements and Other Mandatory Spending	10.8	10.5	10.5	10.3	10.1	10.0
Nondefense Discretionary Spending	4.1	3.9	3.8	3.6	3.5	3.4
Net Interest	3.3	3.2	3.2	3.0	2.8	2.7
Offsetting Receipts	-1.2	-1.1	-1.2	-1.1	-1.1	-1.1
Total Outlays	23.5	22.8	22.4	21.8	21.1	20.6
Revenues	18.6	18.7	19.0	19.0	19.0	18.9
Total Deficit	5.0	4.0	3.4	2.8	2.1	1.7
Debt Held by the Public	41.0	42.2	42.7	42.3	41.4	40.2
Memorandum: GNP	4192	4504	4838	5214	5619	6047

SOURCE: Congressional Budget Office.

Figure 4.

Outlays by Category as Percents of GNP



SOURCE: Congressional Budget Office

Alternative Projections

To show how changes in economic assumptions can affect budgetary outcomes, CBO has prepared two alternative sets of projections (see Table 5). They are intended to illustrate what could happen if economic growth turns out to be higher or lower than projected over the next six years.

TABLE 5. ALTERNATIVE ECONOMIC AND BUDGET PROJECTIONS

	1986	1987	1988	1989	1990	1991
Economic Projections (By calendar year)						
Real GNP (percent change)						
High-growth alternative	4.0	4.3	4.4	4.6	4.6	4.6
Baseline	3.2	3.1	3.3	3.5	3.5	3.2
Low-growth alternative	3.0	-0.7	-0.8	5.4	3.4	3.2
CPI-W (percent change)						
High-growth alternative	3.4	4.3	5.2	6.3	7.5	9.1
Baseline	3.4	4.2	4.4	4.4	4.3	4.3
Low-growth alternative	3.6	4.4	3.9	3.0	2.5	2.5
Civilian Unemployment Rate						
High-growth alternative	6.6	6.3	5.8	5.5	5.1	4.6
Baseline	6.7	6.7	6.5	6.3	6.1	6.0
Low-growth alternative	6.9	8.4	9.9	8.9	8.8	8.7
Three-Month Treasury Bill Rate						
High-growth alternative	6.5	6.1	7.5	8.5	9.7	11.1
Baseline	6.8	6.7	6.4	6.1	5.7	5.4
Low-growth alternative	7.6	7.7	5.9	5.6	4.9	4.3
Budget Projections (By fiscal year, in billions of dollars)						
Deficit (-) or Surplus						
High-growth alternative	-202	-154	-111	-61	-1	70
Baseline	-208	-181	-165	-144	-120	-104
Low-growth alternative	-210	-224	-282	-271	-238	-237

SOURCE: Congressional Budget Office.

The high path assumes growth almost equal to that of the strongest nine-year expansion of the postwar period, which occurred after the recession of 1957-1958. Because the pace of economic expansion up to now has been close to that in an average recovery pattern, this path implies unusually strong growth from now through 1991. As a result, unemployment falls to 4.6 percent in 1991, while the inflation rate more than doubles. Interest rates also rise sharply after 1988, paralleling the higher inflation rate. Interest rates also rise sharply after 1988, paralleling the higher inflation rate.

The low path incorporates a recession starting in 1987, which has the depth and duration of the 1973-1975 recession, and is followed by an average economic recovery. The weaker growth results in lower inflation and lower interest rates than in the CBO economic assumptions after 1987, and higher unemployment rates.

Under the high-growth economic assumptions, the deficit drops swiftly to near balance by 1990 and a sizable surplus in 1991. Under the low-growth assumptions, however, the deficit grows sharply. For example, in fiscal year 1989, the year following the recession incorporated in the low-growth path, the deficit is more than $125 billion above the CBO baseline projection.

AUTOMATIC SPENDING REDUCTIONS

If the Congress fails to reduce the 1987 deficit to $144 billion before the start of the fiscal year, an automatic procedure could be invoked that would make the reduction by sequestering budgetary resources. Under CBO's February assumptions, a 1987 sequestration would reduce total outlays to $989 billion--$37 billion below the baseline projection. As shown in Table 6, there would be almost no growth in total outlays beyond the 1986 estimated level of $986 billion.

The sequestration procedures under the Balanced Budget Act for 1987 would begin in August 1986 when CBO and the Office of Management and Budget send their initial budget estimates either to the Comptroller General or to a special joint committee of the Congress. The CBO estimates presented in this report are made for illustrative purposes and are subject to significant revision over the next six months as the result of legislative actions, changes in the economic outlook, and other factors. These estimates show that relying on the sequestration procedures to reach the $144 billion deficit amount for 1987 would mean reductions of $18 billion in outlays for defense programs and $17 billion for nondefense programs from CBO's projected baseline levels, which include the effects of the 1986 sequestration. The result would be to hold outlays for both defense and nondefense programs to roughly the same levels as estimated for 1986.

TABLE 6. EFFECT OF SEQUESTRATIONS ON BUDGET OUTLAYS FOR 1986 AND 1987 (By fiscal year, in billions of dollars)

Category	1986	1987
Defense Programs a/		
Presequester baseline levels	275	293
1986 sequester	269	284
1987 sequester	269	266
Nondefense Programs b/		
Presequester baseline levels	618	639
1986 sequester	612	632
1987 sequester	612	615
Net Interest and Undistributed Offsetting Receipts c/		
Presequester baseline levels	105	111
1986 sequester	104	109
1987 sequester	104	107
Total Outlays		
Presequester baseline levels	998	1,043
1986 sequester	986	1,025
1987 sequester	986	989

SOURCE: Congressional Budget Office.

a. Budget function 050, national defense.
b. Budget functions 150 through 850, and 920.
c. Budget functions 900 and 950.

To achieve these outlay reductions, defense appropriations for 1987 would have to be reduced 6.2 percent below 1986 postsequestration levels, and nondefense discretionary appropriations would have to be cut by 8.4 percent. The reductions in real terms would be even greater because of the loss of any adjustment for inflation in 1987. For defense programs, new budget authority for 1987 would be limited to $271 billion, which is $30 billion below CBO's baseline projection and $49 billion below the Administration's budget request.

GIVE DEFICIT USING CURRENT POLICY

Chairman **Domenici**. Dr. Penner, I got a summary of your economic and budget outlook. Obviously, I did not read it all. Let me ask you this question.

Did you or can you give us deficits using current policy, and defining outyear current policy for basis of assumptions in the same way that you have done it in the past, rather than assuming that we had already made the cuts?

Dr. **Penner**. That is to say, redo our economics for you?

Chairman **Domenici**. No; have you done that?

Dr. **Penner**. No.

Chairman **Domenici**. What if Gramm-Rudman-Hollings were not around and we just had fiscal policy right where it is today. Could you give us a set of economic assumptions and deficits based upon current policy, even assuming your definition of current policy, which is post-sequester plus inflation.

Is that possible?

Dr. **Penner**. We have not done that, sir, no.

Chairman **Domenici**. Could that be done?

Dr. **Penner**. It gets us into this same kind of dispute—namely; what the effects of various policy changes are and whether we should take account of any other changes in the economy that are not in line with our forecast. For example, as I said, it already looks like oil prices are going to be a little lower than we assumed and so on.

DO ESTIMATING OLD WAY

Chairman **Domenici**. Well, my concern is that when you take the current policy definition of the baseline and then assume for economic assumptions or evaluations it looks as if we have already implemented the emergency deficit reduction plan. There are some who might say we do not have to do anything and things look magnificant.

We would like to be able to say that if we do not do something substantial, here is what our budget deficits would look like based upon our previous ways of projecting them. And I think that number would be very relevant. That trend line would be very relevant in terms of people wanting to do what this committee ends up saying that we have to do. So if that is possible, could you do it exactly as you did it before. That is all that we would be asking you to do. Perhaps I will ask the committee if they would like that and then we will make such a request of you.

I have a number of other questions, but I will yield now, and ask them shortly.

Senator Chiles.

Senator **Chiles**. Thank you, sir.

DEFENSE SEQUESTER AMOUNT

Dr. Penner, if Congress and the President do not agree on the deficit reduction package, for 1987, then next October, how much in defense budget authority would have to be sequestered compared to the CBO defense baseline?

In other words, how much larger would the cut into the defense budget authority be if it is compared to the President's defense request?

Dr. **Penner**. Compared with our baseline, the outlay cut would be about $17 billion or $18 billion. You can see on page 98, of our report, where we are in this regard.

If you look at the 1987 column—I am sorry, that particular table refers to outlays, but that may be a pretty good place to start. We start with $293.1 billion if we had not had the sequestration. We go down to $284 billion because of the sequestration. Next we go to $276.5 billion, which would be the basis used for a 1987 sequestration if no legislative action were taken, and then after the sequestration, we are all the way down to $265.9 billion.

Senator **Chiles**. So, is that $49 billion more than the President's request?

Dr. **Penner**. The $49 billion referred to is the budget authority change.

Senator **Chiles**. The BA change?

Dr. **Penner**. That is right. And let us see, I have that here. If you just look at BA, the President's request is $320 billion. The CBO baseline is $301 billion. And after sequestration, it would be $271 billion. So you can see that the $49 billion is the difference between the $320 billion and the $271 billion.

Senator **Chiles**. So, back again, to my question. If the President and the Congress did not come to some agreement on a deficit reduction package, and the sequester went into effect, from the President's numbers, the budget authority in defense would be cut, according to your figures, $49 billion?

Dr. **Penner**. That is correct, if there was no appropriation in place for defense, yes, when we did our report.

Senator **Chiles**. How much would outlays be cut from his number?

Dr. **Penner**. Well, let us see.

Senator **Chiles**. Now, I want your CBO reestimate of the President's numbers.

Dr. **Penner**. I understand. I think, again, in the President's budget with the CBO reestimate of his outlays, it would be $297 billion. The baseline as shown on page 98 would be $284 billion and then after the sequester it would be $266 billion.

Senator **Chiles**. So, $297 billion from $266 billion, is $31 billion outlay difference?

Dr. **Penner**. That is correct.

Senator **Chiles**. We are looking at $49 billion less in BA and $31 billion less in outlays in defense if we have an impasse reaching sequester.

That is a pretty good number.

Dr. **Penner**. It is very large. As I said before, it means a very different defense establishment than is envisioned by the President.

GROWTH OF TAX EXPENDITURES

Senator **Chiles**. On another question, approximately how much revenue will the Federal Treasury lose in 1986, as a result of tax expenditures? By approximately how much of the total dollar amount are tax expenditures growing each year now?

Dr. PENNER. The way we do things at CBO, we do not really like to add them up since we do each one individually as though nothing changes in the rest of the Tax Code. Others have added them up and got numbers of around $400 billion.

Senator CHILES. Well, maybe I want to ask you to add them up and give me an official CBO number here.

Dr. PENNER. The JCT estimate was $424 billion for 1986, and they had that rising to $461 billion by 1987. The administration estimates were about $385 billion in 1986, rising to $430 billion in 1987.

Senator HOLLINGS. Would you agree or disagree with those?

Dr. PENNER. We generally rely on the JCT for our estimates, sir, and they generally use our economic assumptions to make them. We do not really, at the micro level, do revenue estimates at CBO.

Senator CHILES. So, we are looking at a $37 billion increase under the Joint Tax Committee?

Dr. PENNER. That is right. Again, I think that there are some problems with numbers of that sort. You have to accept them as very crude estimates because all of the interactions between various parts of the code are not necessarily taken account of in them.

DEFENSE REAL GROWTH RATE

Senator CHILES. The administration has argued that their defense request for fiscal year 1987 represents 3 percent over the 1986 level.

Could you tell us how much you would estimate the real growth rate in the defense request relative the 1986 post-sequester defense spending level?

You can assume the President's defense deflator, if you want to, when giving your estimate.

Dr. PENNER. I think, sir, the point that you make is an important one—that the administration's 3 percent starts with the 1986 target in the budget resolution. As I suggested, we are below that target for two reasons. First of all, the appropriations came in below target, and second, we had the sequestration.

What the increase is, really is kind of complicated this year. You would have to be careful of it. It depends on what you compare. If you just look at the increase in new budget authority over new budget authority, we would say that that contains about 8 percent real growth given our deflator of about 3.4 percent.

However, in the continuing resolution, the Congress made certain unobligated balances available in lieu of new budget authority for covering the pay raise, for example. So the program level in 1986 is somewhat higher than would be financed by the new budget authority you gave them. If you compare program level over program level, it is about 6 percent real growth.

Senator CHILES. So, it is a little over 8 percent under the flat figures but if you have program level, the program level is 6 percent?

Dr. PENNER. Yes, sir.

Senator CHILES. In any event over the 3 percent.

I will yield.

Chairman DOMENICI. Senator Hollings?

CBO ESTIMATES ASSUME NO REVENUE INCREASE

Senator HOLLINGS. Senator Chiles is on the same line of thought, as I was on, Dr. Penner, with respect to the CBO report here.

Now, you assume no revenues?

Dr. PENNER. In our baseline, we assume current law, with the exception of certain taxes that go into trust funds.

Senator HOLLINGS. What is the increase? If I remember correctly, the President had estimated somewhere around $73 billion increase in revenues. What page is that on with you? Or what is the CBO estimate for the increase in revenues in 1987 over 1986?

Dr. PENNER. The CBO estimates are on page XIV of the summary in the report. It goes from $778 billion to $844 billion. In other words, about $66 billion. I should say that the President, in his proposals, has certain revenue-raising measures, such as user fees and some other things.

Senator HOLLINGS. Well, the——

Dr. PENNER. Their revenues, if I remember, are about $6 billion above their baseline.

Senator HOLLINGS. I think on that sheet, 3-24, if I remember, overall it was $30 billion but it was only $22.4 billion in cuts, and that is for user fees, and——

Dr. PENNER. They also have some cuts too and things like the tuition tax credit. But net they end up about $6 billion above baseline.

Senator HOLLINGS. You say that you assumed the targets, but you assume how they met in other words?

What I am getting to is that you assume they were met in the sense of cuts, not in the sense in any kind of increase in revenue?

Dr. PENNER. This was a problem for us in doing our economic forecast since we really did assume the target and, as you say, the law tells you nothing about how you reach that target. We rather arbitrarily spread the reductions from our baseline across all outlays and taxes equally since the Congress has freedom, obviously, to do anything it wants in that regard. We just arbitrarily assumed that even distribution. It would not make an enormous difference, however, to our outlook if we changed the distribution very much.

Senator HOLLINGS. Put an even line across both the spending cuts and the——

Dr. PENNER. Tax increases, yes, sir.

Senator HOLLINGS. Tax increases?

Dr. PENNER. Yes, sir; but that assumption was only made for purposes of adding everything up and making sure it was logically consistent and so on.

PERCENT SEQUESTER CUTS WOULD BE

Senator HOLLINGS. Well, we're right into gridlock. In other words, we have this "Make my day" statement from the President and his DOA budget and we're back into the charade. We have one fellow saying, "I want my Social Security," and the other fellow saying "I want my defense." And both of them are saying they don't want to include revenues.

And the deficit goes up, up and away. If we get into gridlock, or if we even pass something and the President vetoes it, and we're not able to override, then as you have indicated, you're going to have to cut from defense alone some $49 billion in budget authority and $31 billion in outlays. It's assumed that the President would not want to do that. And we would want to get together.

Do you have a similar or corresponding figure for nondefense, Dr. Penner? You've given us a figure of $49 billion in budget authority from defense and $31 billion in outlays. What about nondefense?

I think at a previous hearing we were using percentage figures, 18 percent in defense and 25 percent in nondefense. Is that relatively the same?

Dr. PENNER. No; the way things turned out, it would be lower than that. Again, it depends whether you're cutting from our CBO baseline or from the Gramm-Rudman baseline. From the CBO baseline, roughly half of the $37 billion would come out of defense. From the Gramm-Rudman baseline, which is lower, you would be cutting $11.9 billion from outlays, and that would require all types of spending authority—not only appropriations, but guarantees and direct loans and all of that sort of thing—to be cut by $35.8 billion from that baseline.

Senator HOLLINGS. $35.8 billion from nondefense. And what are the percentages?

Dr. PENNER. There's a little technical problem there because the—I'm reading off of the table on page 97 and it does include the outlays for the military retirement. So you should take that into account. But that's a minor problem.

In terms of the percentage amounts, again, we're talking from the Gramm-Rudman lower baseline. So I think these numbers I'm about to give you are again misleading and understate the difficulty. Doing it that way, however, the cut is 8.4 percent from the base in nondefense. It's 6.2 percent in the defense programs.

But again I would like to emphasize that that is from a base that's already been cut once by the 1986 sequestration. It involves no adjustment for inflation whatsoever between 1986 and 1987. So I think that those percentages greatly understate the magnitude of the task before us.

Senator HOLLINGS. And so if we can state it more accurately, how would you state it?

Dr. PENNER. It's very hard, of course, to sort of convert the pain.

Senator HOLLINGS. I'm talking about percentages. It would be approximately what percentage?

Dr. PENNER. It's very difficult to answer that, sir, just because of the way the thing is structured. First you're limited in the COLA's. You have the special rule programs. And in fact you just wouldn't carry out the mechanics of it from the basis of the CBO baseline.

If you want to convert to percentages, a $10 million difference converts to about 4½ percentage points on the nondefense programs. If we added $10 billion to the excess deficit, that would become about 13 percent right away. In terms of the total required reduction, regardless of how it was spread, compared to our baseline, instead of the reduction of $11.3 billion the total would have to be $17 billion.

Senator **Hollings**. And it would be 13 percent approximately in nondefense. And what then in defense? About 10 percent?

Dr. **Penner**. No, I'm sorry, sir. There's a misunderstanding there. I was adding a full $10 billion to the required sequestration amount. Changing it to the baseline you would only add about $6 billion.

But again, I would hesitate to convert that into percentage across-the-board cuts, because that just isn't the way the law works.

UPDATE 18- AND 25-PERCENT CUT FIGURES

Senator **Hollings**. Well, let's work it the way the law works so that we update that 18- and 25-percent figure that was given at a previous hearing. You remember we had you and Mr. Bowsher, the Comptroller General, and of course we also had Jim Miller from OMB. And we generally got the feel that if nothing happened it was an 18-percent defense and a 25-percent nondefense cut. I want that figure updated. Can you give it to us now or later?

Dr. **Penner**. Well, that number, we were all thinking at that time that our 1987 baseline deficit amount would come out much higher than it eventually turned out.

Senator **Hollings**. I understand

Dr. **Penner**. And then we had lower agriculture outlays and a number of other things. The effects of the sequestration were taken into account. So, I think you can say the earlier figure is completely obsolete. The figure that corresponds to that for nondefense programs would be the $17 billion that I mentioned before.

Senator **Hollings**. You use the figure of a $31 billion cut in outlays, and $49 billion in budget authority from defense. I don't want to delay the committee any longer, but Dr. Penner, see if you can update those 18- and 25-percentage figures, and give us now what the percentage would be if nothing occurs, if we're into some kind of gridlock or veto situation on October 1.

And what would be the percentage cut for defense, and what would be the percentage cut for nondefense?

Dr. **Penner**. Maybe there's a better way to answer that. The reason that it's confusing, as I said before, is that the Balanced Budget Act defines a special baseline for the purposes of implementing it. And it is different from the CBO baseline because, if we were in an impasse, we would go back to the 1986 nominal appropriation levels as a basis

So, the end result is that in essence you already assume a nominal freeze on everything before you start cutting. Perhaps one way of looking at it, with the nondefense programs, is to say that the 8.4 percent I gave you already assumes a nominal freeze for that 25 percent of the budget which is subject to the cut.

So, just add the inflation amount to that, say at 3½ percent or so, and that tells you something about how those particular programs would go down in real terms.

Senator **Hollings**. Thank you, Mr. Chairman.

Chairman **Domenici**. Senator Lautenberg.

Senator **Lautenberg**. Senator Sasser has an appointment that requires him to leave, and I would be happy to defer to him.

Chairman **Domenici**. Fine.

Senator **Sasser**. I thank my distinguished colleague from New Jersey

Chairman **Domenici**. Senator Sasser, could I ask a little business question of everyone? Does anybody want a second round, Senator Chiles, Senator Hollings?

What I would like to do is, if anyone wants to join us and inquire, it would appear to me that we will not be here much beyond 20 after, from what I see now. So if any Senators who are not here would like to come and inquire of Dr. Penner, I think we will be finished about 20 after.

Senator Sasser.

HAVE MADE GOOD PROGRESS ON BUDGET DEFICITS

Senator **Sasser**. Thank you, Mr. Chairman.

Dr. Penner, I understood you to say a moment ago that we have made progress on the budget deficit in recent years. Did I understand you correctly when you said that?

Dr. **Penner**. I mean compared with where we were going in 1982.

Senator **Sasser**. Well, I'm astonished. I don't mean to be argumentative, because I would like to agree with you. But I am astonished to hear you say that because I just looked back in our book here and I see in 1981 the deficit amounted to 2.6 percent of GNP. By 1985 it had risen to 5.4 percent of GNP, an increase of more than 100 percent in the space of 4 years.

And sometimes I think we sort of have this era of good feeling going on around here about the budget and the economy, et cetera, and sometimes I think some of this is based more on psychological factors than it is on really objective evidence

I was just a little astonished to hear you say it. What's the rationale for that?

PROGRESS ON CBO FORECASTS

Dr. **Penner**. Let me give you the basis for my statement. I'm thinking of the projections CBO was making just very recently. If we look back 2 years, for example, to February 1984, when the cliche was $200 billion deficits as far as the eye could see, we were much more worried about $300 billion deficits, and indeed, if we assumed a recession we could get them at $400 billion.

There is no way we can create that kind of scenario today without assuming a recession much worse than the worst of the postwar period. We have, after all, had four tax increases since 1981 of some magnitude. We've had TEFRA, DEFRA, the gasoline tax, the Social Security tax increase. We've had extraordinary restraint on nondefense discretionary programs. Those programs are today taking a lower share of the gross national product than they did in the early 1960's before the whole Great Society effort came along.

We've had the 1983 reform in Social Security which admittedly didn't do a lot in the short run, but has major longrun implications for Social Security spending.

We've reformed Medicare by introducing the prospective payments system.

All of those actions I would put in the category of progress, which is not to say that there isn't still a lot to be done. The fact that we could do all those thing, and still end up with a deficit estimated at over $200 billion for 1986, is testimony to how badly off we were a couple of years ago.

Senator **SASSER**. So, in essence, as I understand it, when you say we've made progress, what you're saying is it's not as bad as it could have been

Dr. **PENNER**. That's right. What I am saying is that we've done a lot of things.

Senator **SASSER**. But, still, the budget deficit itself, as a percentage of GNP, there's no argument in 1985, in fiscal year 1985, it was about 100 percent higher than it was in fiscal year 1981. That's the point that I wanted to make.

REASON FOR CBO OPTIMISTIC PROJECTIONS

Dr. Penner, I apologize for not getting here initially when you were delivering your statement; as I understand it, you're optimistic economic projections are based on a number of things: One, falling oil prices; two, the very substantial uptick in the stock and bond market; three, but perhaps as important as anything else, reduced defects that result from the adoption of the Gramm-Rudman-Hollings legislation; four, reduced defense spending—as I read it in your projections, defense spending is flat in the years ahead; and five, a decline in the value of the dollar, and interest rates coming down.

SCENARIO FOR G-R-H DEMISE

Let me pose another scenario for you: What if Gramm-Rudman-Hollings, assuming the Supreme Court holds it unconstitutional, and the President continues to say we're not going to attack this deficit with revenue increases, and Members of Congress saying we can't make the spending cuts that are being projected, then Gramm-Rudman-Hollings would go out the window, would it not?

Dr. **PENNER**. If viewed from CBO's parochial point of view, it wouldn't. What you would do then, as the chairman said initially, is go to the fallback position. Our report would be identical to what it was before. We would just mail it to the Congress instead of mailing it to the GAO.

So, I think things wouldn't change all that much. Of course, you would have to have an explicit vote by the Congress, with the potential of a Presidential veto.

Senator **SASSER**. So we would be right back where we started. The Congress would have to vote on the question of reducing the budget deficit, either by spending cuts, or by tax increases, and that's what we've been unable to do for the past 4 or 5 years.

Again, I'm just playing the devil's advocate here. I'm not trying to be argumentative, and I hope your economic projections are correct.

Chairman **DOMENICI**. Senator Sasser, I think the point he was making was the one I made. You would have to assume that we would pass the joint resolution for the automatic across-the-board cut the way the law is presently on the books. Your point is we may not do that. Correct?

Senator **Sasser**. That's correct. That is my point.

Chairman **Domenici**. We are privileged to do that. I hope we don't, but Congress is Congress; if they don't want to pass it, they don't pass it. And if we have not put together a package, then I assume all this goes out the window and he'd make a whole set of different projections. I guess that's your point, isn't it?

Senator **Sasser**. I suppose that's part of my point, Mr. Chairman, that these economic projections to some extent are based on Congress and the administration doing together that we've been unable to do, as this Senator interprets it, for the past 4 or 5 years.

Now, in your projections, Dr. Penner, you refer to the decline in the dollar, the value of the dollar, and interest rates coming down.

LOW INTEREST AND EXODUS OF FOREIGN CAPITAL

Now, if interest rates come down, and the dollar starts declining if we start seeing an exodus of foreign capital from this country which we've been using to finance about half this deficit. Then what happens to the economic projections that CBO's laid out today?

Dr. **Penner**. I would really like to reemphasize at the beginning that we really do take these deficit targets as the law of the land. In other words, what you are saying is that the law would have to be changed to come up with a different deficit estimate.

Again, I would emphasize that we're doing pretty much what we think we always do, and that is to project on the basis of current law, with the added complication that this year all the details of the spending and tax law haven't been adjusted to the overriding target.

But I think the most important risk enumerated in your different risks is the last risk that you mentioned. Let us suppose that in fact the law was changed, and we went for a much higher deficit than is in the target of the Balanced Budget Act. Let's assume further that this shook up foreign confidence in us and there was a flight from the dollar. I'm not sure I would make that leap automatically, but it certainly is a risk or a possibility in this whole picture. That could cause very severe problems, indeed. A very rapidly declining exchange rate would cause inflation in this country. Although it's hard to predict Federal Reserve actions, but I would think there would be some sort of move to try——

Senator **Sasser**. An uptick in interest rates.

Dr. **Penner**. That's right.

Senator **Sasser**. And that is very damaging to the debtor countries south of the border.

Dr. **Penner**. That's right.

Senator **Sasser**. They could start defaulting.

Dr. Penner. Yes; if worldwide interest rates rose under those circumstances, and again I don't want to make this a forecast of what would happen, this is the risk.

Senator **Sasser**. I understand.

Dr. **Penner**. But certainly all of that is correct.

HOW PROJECTIONS ARE CALCULATED

Senator SASSER. One final question, Dr. Penner, and again I raise this not to be argumentative. I raise this to perhaps indicate in some ways how fragile all economic projections really are.

But in calculating your mediumterm projections out through 1991, you take the longer term historical trends in real growth over a 9-year period. In other words, you average out real growth over a 9-year period.

Dr. PENNER. That's correct.

Senator SASSER. That's accurate, isn't it.

Dr. PENNER. Yes; that's how we do it.

Senator SASSER. Now, you state that such 9-year periods usually contained at least one recession. But because of the uncertainty in predicting the recession or timing the business cycle, what you've done is smooth out the growth rate over the 9-year period to the point that it averages 3½ percent per year from 1988 through 1990. That's an accurate statement, isn't it?

Dr. PENNER. That is correct.

Senator SASSER. Now, in your low growth alternative projection, you project that a recession begins in 1987. If this were to happen, if we were to have a recession in 1987, then in fiscal year 1988, the baseline budget deficit, if Gramm-Rudman-Hollings is still in place, the baseline budget deficit would be $282 billion instead of——

Dr. PENNER. No, sir; $224 billion. The $282 billion is 1988. I'm sorry, did you say 1988?

Senator SASSER. Yes; in 1988.

Dr. PENNER. Oh, yes; I'm sorry. That's right.

Senator SASSER. My point is if we had a recession in 1987, the baseline budget deficit would be $282 billion rather than $165 billion.

Dr. PENNER. That's right.

Senator SASSER. And if this downturn occurred next year, and Gramm-Rudman-Hollings was still in effect, and I think that's dubious, and it was mandating an $108 billion budget deficit for fiscal year 1988, then the Congress would have to turn around and achieve roughly $174 billion in spending reductions or revenue increases in fiscal year 1988 alone to meet the Gramm-Rudman-Hollings deficit reduction targets.

Dr. PENNER. Well, that's right, unless you chose to take advantage of the option of canceling it temporarily because of the recession.

Senator SASSER. Well, I am reasonably confident we would take advantage of that option to cancel it temporarily if we got into a recession and we found ourselves faced with making 174 billion dollars' worth of spending reductions.

Mr. Chairman, thank you, and thank you Dr. Penner, and thank you very much, Senator Lautenberg for letting me go ahead of you.

Senator LAUTENBERG. It's always a pleasure.

Chairman DOMENICI. Thank you, Senator Sasser. Senator Lautenberg?

UNCERTAINTIES TEMPER DECISIONS

Senator LAUTENBERG. Thank you, Mr. Chairman.

Mr. Penner, what I tried to get at earlier was some of the uncertainties that we face as we make our projections off the baseline.

And just to confirm that, you do say in the summary of your report that the performance of the economy could easily turn out to be much better or much worse than CBO projects. You go on to define some of those major uncertainties.

That's a problem of course, that you live with. As we look ahead, we have to temper our thinking in some way with that uncertainty. And I would ask you this: You assumed implications of the Budget Deficit Act in doing some part of the forecasting. You worked off baseline initially, right, but you've applied effects from the sequestration process or the deficit reduction process?

Dr. PENNER. Yes; first of all, obviously, we've taken into account the 1986 sequestration that is in place, and then we have assumed further that the $144 billion target will be met.

Senator LAUTENBERG. Right. But OMB projects 4 percent in growth in GNP in fiscal years 1986, and 1987. CBO predicts 3.6 percent and 3.0 percent respectively in those 2 years. You folks predict a 91-day T-bill rate of 6.7 percent and 6.4 percent in 1987 and 1988. And OMB projects 6.8 percent and 5.8 percent. So they are much more optimistic on the reduction in interest and as well as the growth in GNP.

You don't accept their figures there. Is that correct?

Dr. PENNER. That is correct.

Senator LAUTENBERG. OK. The consequence is that as they look out, you're saying that they are exceptionally optimistic.

Dr. PENNER. They are more optimistic than we are. The difference isn't that huge as forecasting errors go.

Senator LAUTENBERG. Well, they're significant.

Dr. PENNER. They're significant as far as budget forecasting goes.

Senator LAUTENBERG. If you take the difference between 4 percent in 1988 and 3 percent in 1988, it's enormous. One percent of GNP, with GNP roughly $4 trillion, is roughly, $40 billion. Significant numbers.

We're all aware of the fact that productivity growth has slowed. That gets a reference here in the first chapter. What that means is we are becoming less competitive. The growth in income would continue, but the output declines relative to that.

Dr. PENNER. Per manhour it does, yes.

Senator LAUTENBERG. And that's factored in your analysis.

Dr. PENNER. Yes, sir.

Senator LAUTENBERG. And if that continues, do you see it causing a glitch in the growth projection?

Dr. PENNER. I said it was factored into our analysis. We think that productivity growth will return to more historically normal rates. At least, that is what is factored into our analysis—some improvement on the productivity front.

Senator LAUTENBERG. So we do use some subjective evalution as these numbers are put out.

Dr. PENNER. A lot of it, yes.

SHOCK OF G-R-H WON'T DISRUPT ECONOMY

Senator **Lautenberg**. A lot of it. Do you see any possibilities of an impact on economic growth, recession specifically, resulting from the effects of Gramm-Rudman in the couple of years ahead, possibly cutting off the economic growth? Could we be looking at that kind of a result?

All of us are surprised, I think, by the dimension of the cuts, the magnitude of the cuts that are going to result from the process.

Is it possible that we haven't factored in there what might happen to economic growth in the future?

Dr. **Penner**. That's the very reason that we wanted to assume the actual implementation of Gramm-Rudman in doing our forecast and calculations. We wanted to know whether the fiscal shock might be so extreme that it would disrupt the economy. And when we did factor all of that in, we decided it wouldn't for a number of reasons that are elaborated in our report.

First of all, we believe that the markets have taken into account the stronger commitment to deficit reduction. While it's always hard to know how much of a role, we think that played some role in the big interest rate decline that we saw very recently. Economists generally believe that a deficit reduction may shock the economy initially and yet have very good long-run implications. In this case, we think expectations have moved up the good effect of deficit reduction because people really believe that you're going to do at least some of it. So that's one element.

The second important element is that we think there is a very strong tie between the growth in the budget deficit over recent years and the growth in the trade deficit.

So while you may have gotten some short-run stimulus from the budget deficit on the one hand, you've also gotten some short-run contraction from the trade deficit on the other.

Senator **Lautenberg**. The trade deficit is projected to grow even further?

Dr. **Penner**. That is correct, but in our complete forecast, we think that the deficit reduction plays some role in the exchange rate reduction, and at least in 1986 stops the trade deficit from getting worse at such a rapid rate.

Now it does work with time lags. In nominal terms, the trade deficit we project for 1987 is a little worse than in 1986, but in real terms we start to see some improvement. So that plays a role in our analysis as well.

EFFECT OF TAX AMNESTY AT FEDERAL LEVEL

Senator **Lautenberg**. Dr. Penner, one-half of the financial statement, or perhaps less than half, unfortunately, is the income, or revenue side, as opposed to the expenditure side.

Now, when we visited last, I discussed the need to collect some of the revenues that are due but uncollected. And Mr. Bowsher confirmed a $90 billion figure of escaped tax collection.

And I raise this because I intend to propose a tax amnesty that waves civil and criminal penalties for those who come forward and pay taxes. And I recommend that we couple that program with an increase in IRS staffing, increase in enforcement, increased penalties for nonpayment in the future.

We've had some exceptional successes among several States in the country—Massachusetts, Illinois, and New York. Do you have any doubt, or would you comment on what might result from an amnesty program on the Federal level? Do you think we would have any significant revenue gains from that?

Dr. PENNER. I've just never studied that issue in great detail, and I would want to consult with the Joint Committee on Taxation before replying to your question.

Senator LAUTENBERG. OK, I wonder if we could do this: Could we get your staff—you have the capacity to do this?

Dr. PENNER. Yes.

Senator LAUTENBERG. To estimate perhaps the result from the Tax Amnesty Program?

Dr. PENNER. We can consult with the Joint Committee and see what we can do.

THE ECONOMICS OF COLLECTING EVADED TAXES

Senator LAUTENBERG. At the last meeting—I want to make sure that I remember the chairman's response to something I said about tax amnesty, and hope that he'll correct me if I misstate his point—he said that whether we collect uncollected taxes, or create new taxes, we're still collecting taxes. And that is that we're still taking money out of private hands and putting it into Government hands. That in effect the economic impact was the same.

I guess in a way a tax is a tax even if you collect it from sources that are supposed to pay it anyway, but it makes, I think, quite a difference in our approach. There is a question of morality. We cannot permit people to avoid paying taxes because making them pay may affect the economy. We have to get those funds to operate government.

Mr. Chairman, did I quote you correctly? I didn't quote you. I paraphrased.

Chairman DOMENICI. I didn't pass on the morality of it. Obviously, we ought to collect it.

What I said was that I didn't believe economists made any distinction if you're speaking of the same kind of tax.

But if you take $40 billion out of the American economy in taxes that are not today being collected I have not seen anybody that distinguishes between whether they are collected by increasing the income tax or whether they're collected from those who are not paying it, from the macroeconomic negative effect of taxing.

I think I'm right. To do otherwise would be to assume that the illegal money, money you don't pay taxes on, is not in the economy. Now if it isn't, then I'm totally wrong. It would be different if it's hidden out somewhere and isn't used for banking or buying. But let Dr. Penner answer the question.

Senator LAUTENBERG. Do you think that if we collect evaded taxes, Dr. Penner, that we would impair the economy?

Chairman DOMENICI. No, no, no. Wait a minute, now, Senator.

I was making the proposition that I didn't think $10 or $15 billion in new taxes would impede the economy at all, when I was making my point. I suggested in my statement that there are a whole lot of people who want to raise revenues but don't want to tax anybody. A whole lot of people want to cut the budget, but don't want to cut anything. There are a whole lot of people who want to cut defense, but they don't want to cut defense, and you said I have a brand new idea I want to raise revenue, but I don't want to tax anybody. I want to get it from those who aren't paying, and I said that's fine. But from the economic standpoint, I don't know that anybody treats it any differently in terms of the effect on the economy, and that's my point.

Senator **LAUTENBERG**. Well, let me rephrase it. I don't think I said a new idea; I said a good idea. But, Dr. Penner, if we were able to collect $10 billion from those who avoided or evaded paying their taxes, do you think that would have a negative impact on the economy.

EVADED TAXES COLLECTED SAME AS OTHER TAXES

Dr. **PENNER**. Let me try to answer that question just purely from an economic point of view, forgetting the very important point about administering the tax system and morality and criminal action, and so forth. If you catch some people and make them pay taxes they weren't paying before, I suppose it has the same same sort of incentive effect as if they're paying legal taxes. But that has to be weighed against the good effects of closing the deficit.

I think the answer to your previous question holds here. Does closing the deficit really have a big negative effect? And what we've looked at here, of course, is a much bigger change than $10 billion, and we have said the answer is no.

Though at a much lower level of detail, one of the problems with our tax system today is that it's easier to evade taxes if you're in some occupations than if you're in other occupations. That very fact distorts economic activity, and creates some inefficiencies. Hence, the better we can enforce our tax laws, the more efficient we can be as an economy.

Senator **LAUTENBERG**. Thank you, Mr. Chairman.

Thank you, Dr. Penner.

Chairman **DOMENICI**. Let me also say to you, Senator Lautenberg, I don't know how a budget resolution can distinguish between any kinds of revenues in any event. So if you think we could raise $10 billion from uncollected taxes, then maybe you will join with some of us who say let's increase the revenue base $10 billion. You can say that you were for doing it through your system. The implementation is all going to be left up to the Finance Committee anyway.

Senator **LAUTENBERG**. I'm happy to examine any opportunities to get revenues due us. Those are accounts receivable. We have an obligation, I think, functionally as well as morally to make sure that we collect whatever we can. I have several other ideas for collecting revenue without raising tax rates. And I hope that I'll have your support, Mr. Chairman, when those ideas are presented to the committee.

Chairman **Domenici**. Senator Johnston, I didn't ask questions, and I'm going to ask two or three and then yield to you. From my standpoint, I have to leave at noon, so I'll try to be brief so you'll get a chance.

ECONOMIC RECESSION NOT CAUSED BY MODEST TAX INCREASE

Dr. Penner, my first point, is would you change your economic assumptions if we arrived at the Gramm-Rudman-Hollings totals through with 25 percent revenue and 75 percent from reductions in expenditures and/or defense?

Dr. **Penner**. From some other way of doing it?

Chairman **Domenici**. Yes, sir; I mean, you didn't assume any way in here. You just assumed that we were going to get there.

Dr. **Penner**. That is correct. There would be changes depending on exactly how it was done. For example, very obviously, if one were to announce a tax increase on investment, that would change the investment path, and so on. So there would be changes, but in the aggregate I think those changes would be fairly minor. Again, we just don't happen to be able to forecast beyond 1987. We go back to the historical trends for that.

Chairman **Domenici**. So you're not one who would say to this committee, that any kind of revenue, and any amount to be used to reduce this deficit, will cause an economic recession? You wouldn't be saying that, would you?

Dr. **Penner**. No. I guess you could probably invent such terrible tax increases that might have such an effect, but I presume you wouldn't do that.

PRESIDENT'S OUTLAY ESTIMATES TOO LOW

Chairman **Domenici**. Now, with reference to the President's budget and the requisite amount to get to $144 billion, let me see if to this point I understand correctly what you have done.

The President says to get to $144 billion we have to reduce outlays $38 billion off their baseline, and they're having defense increase more than in your baseline. But did you not issue a letter saying that using the President's requested growth in defense, $34 billion in new budget authority, that the estimates of outlays that are in that $38 billion are too low, and they are too low by around $14 billion on the defense side?

Dr. **Penner**. That is our judgment, sir. Between $14 billion and $15 billion.

Chairman **Domenici**. Now, if we were going to adopt everything in the President's budget as is, how much do we have to cut if we are going to give him his defense number. We have to add $14 billion to the $38 billion for starters?

Dr. **Penner**. No, sir; that's not the way to look at it. Our baseline has our high outlay rates in it already. You would only have to add enough to go from zero to the growth he wants, and that would be, as I remember it, about $13 billion.

Chairman **Domenici**. Well, I said $14 billion. You just said $13 billion.

Dr. **Penner**. Well, it's a different——

Chairman **Domenici**. Just using that one notion, that the outlays are underestimated in defense, and he starts with $38 billion. Assume we agree with his budget on defense. I am not saying that we do. But what is the deficit that we have to make up in an orderly manner to avoid sequester? Is it not $38 billion plus $13 billion?

Dr. **Penner**. It's $38 billion plus $13 billion, but that $13 billion is what buys you the 3 percent real growth

Chairman **Domenici**. The President's real growth. Yes. I understand.

Dr. **Penner**. OK.

Chairman **Domenici**. So if you were doing the estimating you would say to give him what he wanted in his budget we need to cut $51 billion out of the domestic side of the budget. Is that correct? Instead of 38.

Dr. **Penner**. Yes, roughly.

Chairman **Domenici**. Now, are there any other estimating errors that you already know of that might affect the $38 billion in the President's request, using his baselines and assumptions? Are there any other errors besides the $13 billion or $14 billion? Estimate.

Dr. **Penner**. We have not finished our work on that. We'll be reporting a week from tomorrow on it. Right at this moment I don't know any, but there is obviously a difference in our economic assumptions, which is going to make a difference in the effects of his proposals on the total deficit

Chairman **Domenici**. If we're looking at the President's budget on defense, we have to find more than $50 billion in outlays to accomplish what he desires and reach $144 billion.

Dr. **Penner**. If that's the only thing you do, yes, sir

Chairman **Domenici**. And from what you know about economics, it's probably higher if we choose your economics, because your economics are slightly lower?

Dr. **Penner**. It could be. There's one oddity, however, in all of this. Though our GNP is a lot lower, the administration's baseline revenues are identical to ours, so we get more per dollar of GNP on the revenue side than they do.

Chairman **Domenici**. All right. Now, you have already told us that the baseline that we're looking at is already a bare bones baseline. Is that correct?

Dr. **Penner**. That is correct.

LARGEST CUT IN HISTORY

Chairman **Domenici**. And, would not $51 billion in outlay reductions be the largest cut that Congress has ever enacted in 1 year in history?

Dr. **Penner**. The largest deficit reduction?

Chairman **Domenici**. Programmatic reduction to accompany $51 billion in outlays in 1 year.

Dr. **Penner**. I would have to check the record. I think the only other possibilities would be those times when we're coming out of wars like the Vietnam situation.

Chairman **Domenici**. But in modern times, Domenici-Hollings Omnibus Reconciliation doesn't touch it? There's nothing that has come close to $51 billion. If it turns out to be 55? I can tell you now for the record it's the largest reduction in history, right off the bat, war years included, but you can check that and answer it for the record.

[The following was subsequently supplied for the record by CBO:]

The Balanced Budget and Emergency Deficit Control Act sets specific deficit targets for fiscal years 1987 through 1991. Because of the uncertainty and conceptual difficulties surrounding any budget projections, the savings necessary to reach these targets can be calculated in a variety of ways.

The Balanced Budget Act sets a maximum deficit of $144 billion in fiscal year 1987. The deficit reductions needed to reach this target depend, of course, on the assumed starting point. CBO's baseline projections assume the continuation of current spending and revenue policies, including adjustments in discretionary programs (both defense and nondefense) sufficient to offset the effects of inflation. These projections show a deficit of about $181 billion in 1987. About $37 billion in deficit reductions, then, would be needed to meet the Balanced Budget Act targets.

The necessary reductions, though, would be different if a different starting point is assumed. For example, the President's budget calls for much higher defense spending than is assumed in CBO's baseline. CBO estimates that the starting deficit would be about $195 billion in 1987 if the President's defense request is included while other spending and revenues are unchanged from the CBO baseline. The necessary deficit reductions, then, would be about $51 billion.

Is there any precedent for $51 billion in deficit reductions in one year — especially if defense spending and revenues are not considered negotiable? This question can't be answered until fairly recently, because the current policy (or current services) assumptions underlying Presidential or Congressional budget proposals were not always specified. This problem arose when the President's proposal, or Congressional resolutions, used economic or technical assumptions that differed from earlier current policy projections, thus hampering the ability to compare these estimates. Thus, while the spending and revenue targets in the President's budget or Congressional budget resolutions were clear, the magnitude of their departures from unchanged policies were not.

Examining Presidential and Congressional budgets since 1982 shows that, while deficit reductions of $50 billion or so in the first year are not unprecedented, they are undeniably large. Presidential budget proposals and Congressional budget resolutions, along with their changes from current policy, are shown in the table below. Excluding revenue and defense changes and focusing on domestic spending, we can see that several recent Presidential budgets—the budgets for fiscal years 1982, 1983, and 1986—have proposed domestic spending cuts in excess of $40 billion. Only two Congressional budget resolutions since 1982 (the first concurrent resolutions for fiscal years 1982 and 1983, respectively) have called for domestic spending cuts of this magnitude. The first budget resolution for fiscal year 1983, furthermore, included large domestic spending reductions attributable to management initiatives and lower, "post-policy" interest rates—savings that are difficult to monitor.

DEFICIT REDUCTIONS IN PRESIDENTIAL BUDGET PROPOSALS AND FIRST CONCURRENT BUDGET RESOLUTIONS
(by fiscal year, in billions of dollars)

	1982	1983	1984	1985	1986	1987
Presidential Budget Requests						
Current services deficit	-36	-126	-232	-208	-230	-182
Proposed deficit	-45	-92	-189	-180	-180	-144
Increase (-) or reduction (+) in deficit	-9	35	43	28	50	38
Increase (-) or reduction (+) in deficit attributable to:						
Revenue changes	-56	13	11	8	-1	6
Defense	-8	-19	8	13	9	3
All other	56	41	23	7	42	29
Congressional Budget Resolutions						
Current policy deficit	-30	-181	-183	-205	-227	NA
Proposed deficit	-38	-104	-170	-181	-172	NA
Increase (-) or reduction (+) in deficit	-8	77	13	24	56	NA
Increase (-) or reduction (+) in deficit attributable to:						
Revenue changes	-51	20	12	10	3	NA
Defense	-5	8	2	9	28	NA
All other	48	49	-1	4	25	NA

SOURCES: Office of Management and Budget; Congressional Budget Office; conference reports on First Concurrent Resolutions on the Budget.

Chairman **Domenici**. When will we have your full report analyzing the President's budget with reference to its estimating versus you and your staff's estimating of it?

Dr. **Penner**. A week from tomorrow.

Chairman **Domenici**. Thank you very much.

Senator Johnston.

Senator **Johnston**. Thank you, Mr. Chairman.

WHAT LOWER ENERGY COSTS MEAN TO DEFENSE

Dr. Penner, I asked Secretary Weinberger the other day what the lower energy costs were likely to mean in terms of savings to the defense budget. That information has not been forthcoming yet that I know of. Do you have an estimate precise or general as to what the savings per dollar or lower energy costs is in the defense budget?

Dr. **Penner**. I think I should probably sharpen up this answer for the record, sir But it's my memory that the Pentagon uses—rounding very crudely here—about 200 million barrels oil equivalent per year. So every $5 would be about $1 billion. But I'll take a closer look at that and correct my rounding for the record if necessary.

[The following was subsequently supplied for the record by CBO:]

In fiscal year 1986, the Department of Defense (DoD) plans to purchase about 194 million barrels of fuel. The President's budget request for fiscal year 1987 includes total fuel purchases of approximately 197 million barrels. These quantities include only direct purchases of oil equivalent, not indirect purchases such as electricity from local power companies.

Based on these volumes of fuel purchases, a reduction of $5 per barrel in the Defense Department's acquisition price would result in annual savings of about $1 billion. The crude oil price projected by the Office of Management and Budget for fiscal year 1987 is just over $24 a barrel. Based on this assumption, the DoD estimates the price of refined product at delivery at $31.50 per barrel.

Senator **Johnston**. You think, 200 million barrels is the gross amount?

Dr. **Penner**. Barrels per year.

Senator **Johnston**. Yes.

Dr. **Penner**. Again, that is a very crude estimate.

Senator **Johnston**. That sounds like a very small amount. Maybe not

Dr. Penner——

Dr. **Penner**. Looking at it a slightly different way, my staff tells me that if prices remain at today's level, and making the important assumption that refiners' acquisition cost comes down in line with the spot prices and the futures prices today, the saving year over year would be about $1 billion.

Senator **Johnston**. Well, they projected, they must have projected their prices based on December, and they've come down over $10, haven't they, since December, at least in the spot markets?

Dr. **Penner**. Frankly, sir, I'm not sure what kind of oil price forecast they used when they put together their budget. I think most of us had declining oil prices. We certainly did forecast a decline. We didn't forecast enough of a decline.

Senator **Johnston**. What did you forecast?

Dr. PENNER. We had the refiners' acquisition cost about $23 per barrel. Now we could be $7 or $8 below that.

Senator JOHNSTON. You made it at $23 at what time of the year?

Dr. PENNER. That was the average for 1986.

Senator JOHNSTON. I mean, was that when you—when did you make that estimate?

Dr. PENNER. We had to begin our forecast last December, and while we had some opportunity to correct things as it went along, the oil markets were so volatile—and I think they're still volatile—that we felt any correction we might make we would regret a week later. So we just made the decision to leave it.

BUDGET AMOUNT SAVED ON MEDICARE

Senator JOHNSTON. If you made a $23 prediction in December, you were very good. Even though that's high now, almost no one was projecting that steep decline at that time.

Dr. Penner, how much is saved on Medicare in this budget?

Dr. PENNER. In the President's budget? Again we would like to look at that carefully and report a week from tomorrow on that. Our baseline just returns Medicare fees to where they would be under current law.

Senator JOHNSTON. And I wish you would also, as part of that, give us an estimate of what the costs for the average, or the mean cost, I guess it would be, for a Medicare recipient, what it would be over a period of 1 year or 3 years.

Dr. PENNER. I think we can make an estimate of that.

[The following was subsequently supplied for the record by CBO:]

The President's budget for fiscal year 1987 proposes reductions in Medicare outlays amounting to $4.7 billion in 1987 and $52.8 billion over the 1987-1991 period.

About half of the proposed spending reductions would be achieved through higher beneficiary costs that would be paid by, or on behalf of, the 31 million people enrolled in Medicare. The premiums paid by enrollees in the Supplementary Medical Insurance program (Medicare Part B) would be increased gradually to cover 35 percent of program costs, in contrast to 25 percent at present. Premiums paid by third parties (such as states) would be raised to cover 50 percent of costs. Higher beneficiary costs would also result from raising and indexing the deductible, requiring employers to offer the same health insurance coverage to employees over 69 as to other employees, and other proposals.

Most of the remaining savings would be achieved through limiting reimbursements to hospitals, primarily for capital costs and medical education costs. About 10 percent of the total savings would be accomplished by limiting reimbursements to other providers, such as physicians and laboratories.

The effects of these proposed changes on an average beneficiary are difficult to quantify. Premium increases, of course, would be paid directly by participants (or in some cases on behalf of participants, for example, by states). CBO estimates that the monthly premium paid by individual enrollees would reach $38.50 in 1991 compared to $21.30 under current policy. For other proposals, though, the effects may be split in complex ways among Medicare beneficiaries, other patients, and providers.

A more detailed analysis of the Medicare changes proposed by the President appears in "An Analysis of the President's Budgetary Proposals for Fiscal Year 1987," recently issued by CBO.

SALE OF PMA PROPERTIES

Senator JOHNSTON. Dr. Penner, as part of this budget, the Power Marketing Administration's properties are being sold. Bonneville Power—I think they have those slated for sale at the discounted cost of the remaining obligation to the Government, or of the Government, which is, as I understand it, only a fraction of the cost.

The Heritage Foundation, I think, says that these PMA properties are worth $60 billion. It seems to me the proposed sale price would be more in the neighborhood of $12 billion.

Would you supply for the record an estimate of what the sale price would be using the methodology proposed in the budget, and your best estimate of what the market value would be as well as the replacement value of these dams?

Dr. PENNER. We'll give it a try, sir. It might be a hard thing to do.

Senator JOHNSTON. I know it's going to be Kentucky windage——

Dr. PENNER. We haven't sold enough of them before to have much experience with that sort of thing. But we'll give it a shot.

[The following was subsequently supplied for the record by CBO:]

The President's budget recommends selling the five power marketing administrations (PMAs) in the Department of Energy: the Bonneville Power Administration (BPA), and the Alaska, Southeastern, Southwestern, and Western PMAs. These agencies sell and transmit the electricity produced at federal dams owned and operated by the Corps of Engineers and the Bureau of Reclamation. The Administration believes that marketing electricity is no longer a federal responsibility, and that states, localities, and private management could be more responsive to customer needs.

Estimates of the potential receipts from selling the PMAs vary greatly because of uncertainty regarding the market value of the systems and the tax status of the buyers. At a minimum, it would be desirable for the sales price, combined with the possible tax effects of a sale, to be at least equivalent in value to the income that would accrue to the government if the sale did not occur. Under the current system, the PMAs owe the Treasury about $12.6 billion for past federal investments, which would be paid over the next 50 years at an average interest rate of about 4 percent. The present value of this future income would be about $8 billion, assuming a government discount rate based on CBO's baseline economic assumptions. To remain neutral relative to current policy, the selling price would have to reflect this value, and adjust for any tax effects of the sale. If the sales were financed entirely by tax-exempt bonds, for example, the government would need to recover over $12 billion to obtain a value comparable to current policy. Alternative methods of financing could yield a lower minimum value.

Market factors could produce a higher selling price, depending on the terms of the sales and on the economic interests of the prospective buyers. If the market were to value the system based on the cost of new, large hydroelectric plants (about $1,000 per kilowatt), the value of the PMAs' assets could approach $33 billion.

For its budget estimates, the Administration assumed that the buyers would be willing to pay an amount equivalent to the unpaid balance of the federal investment. Under current projections, the unpaid balance is expected to increase from $12.6 billion at the end of 1985 to $13.9 billion at the time of the sales. Thus, the President's budget shows sales receipts totaling $13.9 billion, of which $8.9 billion would result from the sale of Bonneville.

CBO's preliminary estimates are lower—totaling about $12.3 billion by 1991. CBO expects lower receipts from the sale of Bonneville ($7 billion, as compared with $8.9 billion), but slightly higher receipts from the sale of the other PMAs ($5.3 billion, as compared with $5 billion). These amounts would be sufficient to ensure that the government received the value of its currently projected income stream under certain financing assumptions.

Our preliminary analysis suggests that several factors could limit the market value of the Bonneville system. First, few regions outside of the Pacific Northwest could readily absorb the volume of power to be sold, thereby limiting the competition for the power. As a result, the market value of the power may be determined more by the price of existing supplies than by the price of alternative, future supplies. Second, the terms and conditions attached to the sale also may limit its marketability. Our estimate assumes, for example, that the buyer would take over BPA's $6 billion obligation for three nuclear units, and would continue the residential power exchange program. A buyer's ability to recover the sale price also may be affected by federal or regional interest in limiting the rate impact on the aluminum industry or irrigation users. Finally, once the system is sold to nonfederal entities, the price of the electricity would be subject to rate regulation by federal or state agencies.

In contrast, the market value of the other PMAs may be greater than the amounts owed to the Treasury, because these sales may be subject to greater competition, and fewer terms and conditions.

Senator JOHNSTON. If necessary I think you could take the income stream to be projected from market value of the electricity—not this discounted brother-in-law price they have on Bonneville—take market value of the electricity and capitalize that income stream and come to some kind of value on it

Do you understand? I don't ever expect these dams to be sold because I think there are too many people who would throw their bodies in the way of that crane. But I think it is interesting to look at what the budget means when it talks about privatization. It's not privatization at all. It's kind of a brother-in-law sale, or you might call it privateering by selling this very valuable asset for a fraction of its value and then saying look how the invisible hand has worked to help our budget.

DIFFERENT ESTIMATING METHOD PRODUCES HIGHER DEFICIT

My final question, Dr. Penner: If you use the methodology for estimating defense that you have in the past, that is, to not assume that a law is going to necessarily result in changes until the changes are actually made, what would be your baseline on the deficit in 1990? Would it not be around $215 billion instead of $120 billion if you allowed for 3 percent real growth in defense? Do you recall that figure?

Dr. PENNER. I believe we have it in our report on page 69, sir. You can see the deficit calculations under different definitions for defense. Now, as I said before, in past history we've used the budget resolution targets for that. So, you can see that under that assumption the deficits fall from $208 billion in 1986 to about $160 billion in 1991.

Senator JOHNSTON. If you used 3 percent real growth as the administration budget would propose, what would the deficit then be?

Dr. PENNER. The administration budget defines the 3 percent real growth on the basis of the budget resolution. Now, it's a little bit below that because of assumed inflation savings. But it would be just a little bit below what you see in the bottom line of page 69.

Senator JOHNSTON. Thank you, Dr. Penner.

Senator GRASSLEY [presiding]. Do you have some questions, Senator Chiles?

Senator CHILES. I've had a first round, sir.

DOD UNOBLIGATED FUNDS

Senator GRASSLEY. OK. I would like to ask if you have had a chance to look at unobligated funds in DOD. I want you to focus on that for just a moment, particularly, the extent to which the figure or column that is classified unobligated funds has been growing recently, both as a percentage of the budget, and then in real dollars. And even beyond the projection of the Defense Department.

In other words, they project for the year fiscal year 1985 having $51 billion in unobligated funds, and now I think that they're projecting $62 billion and I think I've given figures to the committee that show that figure ought to be $67 billion. But it doesn't matter whether it's $62 or $67 billion.

Is there any good news in that, in the sense that we could appropriate less money to defense? I'm not talking about what Congress has the power to do and what we might decide to do if we want to just spend less money on defense. But can't we still be able to keep the plans that the administration has for defense, and appropriate less because we're appropriating money faster now than they can spend it?

Dr. PENNER. You are right sir. Very recently the unobligated balances have gone up relative to new budget authority. They're up about to the level they were at in the late 1970's—that is, 1979 and 1980. They went down a little bit between 1981 and 1983. I think the bit of good news in those numbers that some of those dollars result from the fact that we overestimated inflation in the past, and there are some savings there.

We have not been able to identify exactly how much remains right at this moment. We estimated the excess looking back at some $23 billion over the period of 1983 to 1985. We don't account very well for mistakes in estimating inflation. We did a paper—and we would be glad to supply you a copy of it—for the House Armed Services Committee outlining different approaches that might identify the excess more usefully than we do today.

EVERYTHING AUTHORIZED NOT OBLIGATED

Senator GRASSLEY. Well, one of Secretary Weinberger's responses to me was that there isn't such a thing as unobligated funds. Those are obligated and they will be spent. Your reaction to that, please?

Dr. PENNER. They were obviously authorized in the first place with the intent of obligating them. Certainly he is right about that, but we don't always obligate everything that has been authorized. Indeed, last year in the continuing resolution we moved some of those unobligated balances around so that they could be used for pay instead of in the accounts that they were in in the first place.

Senator GRASSLEY. Well, you emphasized misjudging for inflation. What part of unobligated funds would be related to that?

Dr. PENNER. Well, as I said, we don't have a good number for that.

Senator GRASSLEY. So there's reasons other——

Dr. PENNER. It's not explicitly identified.

Senator GRASSLEY. Well, then there's a lot of reasons other than just misjudging for inflation.

Dr. PENNER. There are other reasons, of course.

GNP PROJECTIONS

Senator GRASSLEY. On another point: Maybe I first better ask if for fiscal year 1987, you're projecting real GNP at 3 percent. I'm looking on summary roman numeral XVII

Now, that's one percentage point less than what the administration is projecting?

Dr. PENNER. That's correct.

Senator GRASSLEY. What is the difference—and you probably have already answered this for other people—but the difference between the 3 percent growth and the 4 percent growth, would that make the budget deficit graver?

Dr. PENNER. We have rules of thumb that translate changes in estimates of real growth into budget deficits. You have to be very careful about using those this year, because of a peculiarity in the administration's and our estimates. Even though this year the administration estimates a much higher GNP than we do, the revenues they estimate on their baseline are exactly equal to ours. There is an unusual difference of opinion between us about how much of the gross national product is going to be taxable—a difference, for example, in estimating the growth of fringe benefits and other nontaxable things. So this year you really can't use our normal rules of thumb. We'll have a more precise answer for you, sir, a week from today when we provide our complete estimates of the President's budget.

Senator GRASSLEY. Well, is that typical, going back to recent years where there's been a difference between CBO and the administration on GNP? Have you been closer on tax revenue coming in? Or is this a different picture this year?

Dr. PENNER. I think it fair to say that usually our estimate of the amount of taxes you get out of a dollar of GNP is a lot closer than it is in this round of estimates.

Senator GRASSLEY. Are there any more questions from any Senators?

Then I think we're done unless Senator Gorton has any.

Senator GORTON. Thank you, Mr. Chairman. I just came in. I do not have any questions.

Senator GRASSLEY. Thank you. The meeting is adjourned.

[Whereupon, at 11:42 a.m. the committee was adjourned.]

WRITTEN QUESTIONS FROM SENATOR LAUTENBERG TO DR. PENNER AND THE RESPONSES

Question 1. Impact of lower oil prices. Dr. Penner, your economic forecast assumes an 18% drop in oil prices, from late 1985 levels. But, as you note in your report, prices have fallen 46%. What do you project would be the impact on various economic indicators if the price were to stay that low?

Is it safe to say that an oil price drop would indirectly increase tax revenues as a result of increased economic growth? By how much? Could you supply the Committee with an estimate of how your economic and budget forecasts would vary, if oil prices do stay at their current level?

Answer 1. Oil prices are now, as you note, substantially below what CBO assumed in its winter economic forecast. The oil price decline has already brought sharp falls in the prices of gasoline and home heating oil and a consequent sharp short-run improvement in oil consumers' real incomes. Domestic oil producers and the banks that lend to them have suffered a large loss of income that does not, however, offset the gains elsewhere in the economy. The oil price decline, therefore, contributes to economic welfare in the United States, and does so more strongly if it is expected to persist. Thus the reduction in oil prices would be expected to lead to stronger real growth in the economy in the short run. If the oil price decline is not reversed, as many analysts think it will be in a few years, productivity and real GNP could be permanently increased.

Other things have changed since the CBO winter forecast. In particular, it now appears that the economy was weaker at the end of 1985 than CBO had assumed, so that it will now take stronger growth just to reach the forecast real GNP levels for fiscal year 1987. In addition, the exchange rate has fallen faster than CBO assumed, and interest rates are below CBO's forecast. CBO has not made a new economic or budget forecast that reflects all these factors, and in accordance with its long-established practice will not do so until the normal summer forecast update, unless requested to do so by the chairmen of both House and Senate Budget Committees.

It is not entirely clear, moreover, even if growth is stronger than the CBO winter forecast, that tax revenues will be correspondingly higher, since prices will be lower than in the CBO forecast. Thus the tax base is likely to rise much less than real GNP relative to the CBO forecast, and could even decline.

Question 2. Impact of an Oil Import Fee. What would be the impact of an oil import fee? Wouldn't it forfeit many of the benefits of the oil price drop? Wouldn't it increase inflation? Reduce GNP growth? By how much if a $4 a barrel fee were imposed?

How would the fee affect trade? Let's say we tax the oil that our industrial firms use, but Japan doesn't tax its oil. Let's say European firms don't tax theirs. Wouldn't that put our firms at a disadvantage?

How would the fee affect outlays? In a set of tax options that Treasury gave to the Finance Committee, Treasury estimates that a $4 a barrel fee would bring in $8.4 billion in revenue. But, wouldn't the tax affect outlays, too? Wouldn't Defense pay more for oil? If the fee pushed up inflation, wouldn't inflation-adjusted outlays go up? What would be the affect of a $4 a barrel fee on outlays?

Answer 2. CBO is now preparing an analysis of various oil tax options—including an oil import fee—on behalf of Senators Domenici and Chiles. We will be pleased to share the results of that analysis with you when it is completed, most likely late in April.

An oil import fee could, as you state, offset some of the economic effects of lower oil prices. A major difference, however, between an oil import fee and an increase in world oil prices is that the import fee would reduce the federal deficit, with the associated positive economic effects.

Any tax on oil would raise the costs of U.S. businesses, and to the extent that parallel costs in other nations did not rise, some U.S. firms would be placed at a competitive disadvantage. It should be noted, however, that oil taxes are generally lower in the United States than in the other industrialized countries, and that many of these countries are in the process of further raising their taxes as world oil prices fall.

Finally, oil taxes would change federal outlays, but in conflicting ways. The U.S. government consumes approximately half a million barrels of oil per day; the cost of this consumption would rise with an oil import fee. Certain other outlays, however, would tend to fall. Offsetting receipts from the Naval Petroleum Reserves would be increased as would bonuses and royalties on Outer Continental Shelf oil and gas leases. Outlays would also fall if there were fewer defaults on the guaranteed loans of the Federal Ship Financing Fund or if there were fewer failures of federally insured financial institutions. The net effect of all of these factors on outlays would depend to some extent on the level of oil prices prevailing in the absence of the assumed oil tax. Moreover, in addition to these direct effects, outlays would be affected by changes in the price level, economic activity, and interest rates that might result from the oil tax.

Question 3. On Tax Enforcement. The Administration has proposed a staffing increase of 2500 IRS agents a year, for three years. OMB projects an extra $600 million in revenue in FY87, $1.5 billion in FY88, and $2.6 billion in FY89. Do you accept those figures? If not, could you supply the Committee with your own estimate?

Answer 3. The appropriation of increased funds for IRS enforcement could generate considerable additional revenues in increased collections. The President's fiscal year 1987 budget preoposes to increase IRS enforcement funding for 2,500 additional members of the IRS examinations staff each from 1987 through 1989. The Administration estimates that this proposal would increase funding above baseline levels by $0.6 billion from 1986 through 1989 (including a 1986 supplemental appropriation). This proposal would increase collections by $4.7 billion over the 1987–1989 period ($0.6 billion in 1987, $1.5 billion in 1988, and $2.6 billion in 1989). CBO agrees with these estimates but emphasizes that such revenue increases cannot be included in scorekeeping or in baseline revenues until legislation appropriating such funds has been signed into law and necessary administrative actions initiated.

Question 4. On the Budget Baseline. Did CBO assume the President's proposed recissions or deferrals in its budget baseline? If so, please explain why, and provide alternative baselines without such an assumption.

Answer 4. The CBO baseline reflects current law, as enacted by the Congress and implemented by the Administration using whatever discretion or authority is provided to it under law. Deferrals are reflected in the baseline, because they are Administration actions authorized by the Congress. While that authority is under legal challenge, it has not been overturned by the courts and is being exercised by the Administration. Of course, the Congress has the authority to disapprove deferrals, and may well disapprove some of those currently in effect. However, CBO does not and cannot predict Congressional actions. We can only reflect actions to date. (For example, the reconciliation bill is not reflected in the baseline, because it had not been enacted when the baseline was prepared.)

Recissions are a different matter—because, unlike deferrals, they require Congressional action before taking effect. Just as we do not project Congressional action with regard to deferrals, the baseline includes no prediction of actions involving recissions; therefore, recissions are not included in the baseline.

Finally, the baseline, by remaining "neutral" as to future Congressional actions, provides the Budget Committees and the Congress the opportunity to assume whatever actions they wish in developing the budget resolution. We have provided the Budget committees full information on how the resolution can be structured so as to assume an overturn of any of the deferrals.

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1987

TUESDAY, FEBRUARY 18, 1986

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 2:05 p.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Boschwitz, Andrews, Grassley, Quayle, Chiles, and Lautenberg.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and John Hilley, senior economist.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The hearing will please come to order.

I am pleased to welcome to our committee the Secretary of the Treasury, the Honorable James Baker. About this time last year, you made your first appearance before this committee as Secretary. Since then, you have found time to push tax reform through the House, move the G-5 countries toward better economic coordination, propose new roles for the World Bank and private banks in the growth crisis that exists abroad, and initiate a very healthy decline in the dollar.

Throughout these successes, you have maintained close ties with many Senators and Representatives.

We on this committee enjoy a good relationship with you, and we compliment you. I have concluded that the economic policy of this administration is led to a substantial degree by your leadership, and I compliment you for us.

We hope very much that the magic touch you have brought to the administration's international economic prestige will help us move the budget forward.

The focus of today's hearing is the budget deficit and the problems that it brings, how we on this committee can work to solve it, and how we and the administration can work together to avoid another deadlock.

PRESIDENT'S BUDGET MEETS DEFICIT TARGET

I would like to make my position clear. At Wednesday's hearing with Jim Miller, the Director of OMB, I made remarks about what

I thought we ought to do. It is my honest opinion that the President has indeed put forth a budget plan, based upon the advice that he has received, that meets the $144 billion deficit target of Gramm-Rudman-Hollings.

Certainly, as we have in the past, we can argue about the estimates. But the point is that the President has sent his program up here He has put something on the table, and now it is time for us and the Congress to act, and it is our job to produce a budget. We have to begin by developing our own plan. It is not enough to stand back, as some Members of the House have done, and only criticize what he has proposed.

It seems to me that some Members of Congress want to solve this problem by taking as little real action as possible. I have a new theory about the budget. I listened to those who want to raise taxes to solve the problem, but they want to do it in a way that no one's taxes really go up. People want to cut defense spending, but they do not want defense to really go down. And some want to cut domestic spending without really taking anything away from anyone.

If that is how we are going to go about this budget plan, it is not going to work. Obviously, we are going to have to reduce substantially the commitments of this Government. We will have to do some of that on the defense side, and we are going to have to do a great deal of changing our commitments on the domestic side if we are going to get by without triggering the Gramm-Rudman-Hollings second round of sequestrations.

I have tried to take a first step by indicating publicly, as you know, Mr. Secretary, up front, that I do not think that we can pass a budget that does not have some new taxes in it, and some balance between defense spending and nondefense cuts.

So I am hopeful that those putting budgets together on the other side, in the House, that they will come forward and say how they intend to approach this deficit problem.

I am quite confident that we can build a budget here. Indeed, I believe that many Members in the House are similarly committed to moving toward a budget plan. We cannot afford an impasse like last year.

MOMENTUM COULD BE LOST WITH INTERNATIONAL ECONOMY

There will be another and perhaps more serious loss if we drag our feet, argue among ourselves and do nothing. The loss will be in the momentum that you have built up in dealing with the international economy.

Without a budget for the United States, future meetings of the G-5 countries will be soured by our inability to match your commitments with economic policies.

As much as any Cabinet officer, you, Mr. Secretary, know that the path toward international competitiveness and cooperation runs straight through the budget issues that we are facing this week. In countless meetings with financial ministers, you have heard how important the U.S. budget is in their economies and in the trade imbalances that threaten the world's financial systems.

I am quite concerned that your progress in the international sphere would be undermined by drawn-out negotiations on the budget. In my judgment, we should deal with the budget, get it over with, and move on to other successes.

I am truly hopeful that we will not reach an impasse, that level heads in the Senate and the House will see that it is in the interests of both parties and all of our constituents to move forward.

I will conclude with these thoughts: First, the budget is a bipartisan issue. It is bicameral; both Houses have to join in the solution; second, the budget will not improve with age and should not be dragged out. Negotiation by attrition did not work last year and will not work this year. The problems will grow, special interests will become more powerful, and all the other legislative issues will be in a shadow until the budget is dealt with; and third, dealing with the budget is a necessary first step, not only to legislation, but to the progress of the type that you want to continue in the international arena

I am pleased to have you here.

I yield now to the distinguished Senator from Florida.

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Thank you, Mr. Chairman.

We are pleased to have you with us today, Mr. Secretary, and we welcome you to the committee.

Since you assumed office, I have certainly been impressed with the approach you have taken on a number of key issues. You have shown both initiative and insight in approaching the international debt crisis with a view to promoting growth. And you have shown real leadership by trying to coordinate work on the broad, economic questions with other nations of the world.

It is my belief that this country has to lead by example, with fresh and vigorous steps to try to open up foreign markets to our goods, and to set the pace for other nations in the search for their economic stability.

Of course, here at home our most nagging problem is the Federal deficit, and with the budget season in full stride, we can expect to hear a whole range of ideas about deficit reduction.

PROMISING TALK

One idea that certainly seems to be gaining steam is what the chairman and other Senate Republicans have talked about today, that we might have to include revenues. It seems to me the mere fact that the Republican leadership has raised the issue underscores just how serious the deficit problem really is. Already we have had strong indication that the White House is willing to consider an oil import fee, but so far the administration seems reluctant to apply those revenues to deficit reduction. That strikes me like saving water for the lawn when the house is on fire.

I am in favor of reforming the Tax Code. But it seems to me—and I know we have to look carefully at the overall business tax burden to make sure we do not stifle corporate investments. But with about $425 billion in tax expenditures this year, and they are projected to grow by $35 billion next year, it seems that we have room to protect business investment without having to plow any new revenue source into maintaining some business investment credits that are there today.

So today I will be interested in hearing your thoughts on the deficit and the need for revenue. I will also be interested in knowing your sentiments on the oil import fee.

As I have looked through the Economic Report of the President this morning, the section on fiscal policy links the deficit to Government spending and assigns little impact to the tax cuts. The tide rising among my Republican colleagues for tax action on the deficit suggests that a meeting of the minds with the President is essential, if we are going to get the deficit down to size.

I certainly look forward to your thoughts on this question as we start working on one of our most knotty problems.

Chairman DOMENICI. Thank you very much, Senator Chiles.

Mr. Secretary, you may proceed. Your written testimony is before us and will be made a part of the record. If you care to give it in its entirety, that is up to you; if not, it is in the record.

Senator BOSCHWITZ. Mr. Chairman, I would just like to say that I have no opening remarks inasmuch as you said what I would have said. The Genocide Convention is on the floor, however, and I am going to have to leave after the testimony of the Secretary, for which I apologize.

MUST ACT SWIFTLY ON RESOLVING BUDGET

Chairman DOMENICI. Thank you very much, Senator Boschwitz.

Mr. Secretary, I just want to make this one point.

I am sure you are fully aware of the large, broad spectrum of economists who say if we can live up to the Gramm-Rudman-Hollings targets—and that has nothing to do with how we get there, the mix, or the rest—would have a real positive impact for us in terms of fixing some of the lingering problems here at home that will accommodate to some of the problems around the world.

So, if you hear me talk about putting something together, you understand that I think the chances of getting the totals reached diminish with the passage of time. I think if we let this thing go unresolved into August and September because we have an automatic trigger out there, elections coming along, and the Court has not decided the case until July, I do not think we are going to put a package together. And it is in that context that I express the concern that you have heard publicly and privately from me.

Please proceed.

STATEMENT OF HON. JAMES A. BAKER III, SECRETARY OF THE TREASURY

Secretary BAKER. Mr. Chairman, thank you very much, and thank you, Senator Chiles, for your kind comments, and I thank Senator Boschwitz as well for echoing those.

I do have a written statement, which I appreciate your receiving into the record.

I do not disagree with you one bit, Mr. Chairman, with respect to the importance of reaching those targets, and the President's budget obviously, at least suggests a path to get that done. I think it is a viable path myself. I have already testified once with respect to it. And I am delighted that it would appear that the budget is going to receive serious and detailed consideration.

If I might, I would like very much to read a brief statement, which is a summary of my written statement.

Chairman DOMENICI. Please do.

Secretary BAKER. I am delighted to be here this afternoon.

BUILD ON ECONOMIC PROGRESS

I would like to point out that we would like to build on the foundation of what we see as solid economic performance over the past 3-plus years. The current economic expansion has now moved into its fourth year, and it shows, I think, few signs of slackening. Growth was relatively slow at some times during 1985, but by year-end, the economy was gaining momentum

A couple of favorable features of last year's economic performance deserve, I think, at least passing mention. First of all, consumer price inflation at 3.8 percent remained in the 3.8- to 4-percent range for the fourth year in a row, and is down sharply from the double-digit rates that we saw in 1980.

Employment has risen strongly in the current expansion, by over 9½ million people. The unemployment rate has been reduced to below 7 percent, and further progress is expected.

Last year's financial market performance was also encouraging. Record amounts of credit flowed to private borrowers, despite the persistence of large Federal budget deficits. Short-term interest rates are down on average by about one-half percentage point in the past year, while many of the long-term rates are down by about 2 percentage points. The prime rate is down to 9½ percent, which is the lowest rate in 7½ years. Ideally, we would like to have seen it come down further, and perhaps we can work toward that end.

All of this, I think, added up to a year of solid economic performance in 1985. The stage has been set for sustained expansion in output, jobs, and income. This is one of the most important prerequisites, obviously, for improving the budget picture as well as the financial security of the American people.

During the current expansion, strong economic growth has been achieved in a much less inflationary environment than in the late seventies, and we should strive to extend that good record into the future

Our forecast calls for 4 percent real growth during the four quarters of 1986. I think this is a reasonable expectation, particularly in light of the recent activity with respect to oil prices. The consensus private forecast has been a little bit lower, around 3 percent, but the recent economic numbers are causing some upward adjustment in the private forecast.

The inflation outlook is also relatively promising, although the fall in the external value of the dollar will eventually begin to exert a little upward pressure at some point.

The Federal Reserve obviously needs to remain alert to the needs of both the domestic and international financial situations. While they never lack for critics and there is always room for disagreement on the wisdom of some of their specific actions, it seems to me that the Federal Reserve has been doing a good job recently.

DOMESTIC INFLUENCE OF INTERNATIONAL ECONOMY

I would like to turn briefly now to the influence of the international economy on our economic and fiscal situation. As a result of intensified efforts at promoting a favorable convergence of economic performance among the major industrial countries, we have seen some improvement in the world economy. We hope to build on the progress this year and to see stronger growth abroad. That trend would have a favorable impact on trade and economic growth in the United States.

Exchange markets have recognized these developments. Well over half of the dollar's rise on a real trade-weighted basis against other industrial countries from the end of 1980 to last winter's peaks has now been reversed. This is good news for U.S. industry and it is good news for U.S. agriculture.

The U.S. trade deficit is likely to level off later this year. These developments should contribute to U.S. growth and to a more sustainable medium-term pattern of current trade and current account balances.

The G–5 meeting last September contributed to these developments. Our recent meeting in London showed that all countries were working to continue efforts for sustainable growth.

Another favorable development has been, as I mentioned, the downward movement in world petroleum prices. Although not without its costs, on balance this should increase growth, and it should lower inflation in most of the world.

LARGE DEFICITS DUE TO HEAVY SPENDING

There are two major items on this year's fiscal agenda: deficit reduction and tax reform. The large budget deficits we face are due to excessive Federal spending. Certainly, it is not because the American people are undertaxed. As shown in a chart attached to my statement, receipts are running a bit above the longrun historical average as a less share of GNP, and despite frequent claims to the contrary by some, the 1981 Reagan tax cuts are not responsible for our current fiscal difficulties.

Our problems are on the outlay side of the budget, and that is where the corrective action needs to be taken. It would seem that Congress shares this view and is serious about cutting the growth in Federal spending.

Outlays will continue to grow in absolute terms along the path projected in the new budget, but the rate of advance will be reduced significantly. Between fiscal 1985 and fiscal 1991, nominal Federal outlays would rise on average about 3 percent per year. In the prior 6-year period 1979 to 1985, the rate of growth was about 11 percent per year. Along the path projected in the new budget, Federal outlays would decline steadily as a ratio to GNP from 24 percent in 1985 to about 19 percent in 1991.

Receipts will be growing strongly in absolute terms as the economy itself grows, but receipts would remain close to a 19-percent ratio to GNP—slightly above historical experience.

Receipts are projected to rise by about an average 7½ percent annually between fiscal 1985 and fiscal 1991, close to the 8-percent rise averaged in the previous 6-year period.

With receipts growing normally, and outlay growth restrained to a lower path, the budget will move into balance by 1991.

SPENDING REDUCTIONS WON'T BE EASY

The reduction in the growth of expenditures required to balance the budget by fiscal year 1991 will not be easy, but the effort deserves strong bipartisan support. It can be done the hard, crude way via sequestration across the board, or it can be done more rationally and selectively with respect for appropriate priorities. The President's budget is carefully drawn to meet the Gramm-Rudman targets while preserving essential programs of the highest national priority.

The only alternatives to the domestic spending cuts emphasized in the President's budget, Mr. Chairman, are to raise taxes, to lower defense spending, or to cut Social Security benefits—none of which are acceptable to the administration.

There should be no illusion that tax increases will somehow provide an easy way out. The President has expressed his views on this issue clearly and consistently. He is firmly opposed to damaging the economy by increasing taxes. Defense, which is the most essential duty of the Federal Government, most be maintained. So must the social safety net, including Social Security and entitlement programs for the needy.

TAX REFORM

Our other major domestic policy priority is to achieve meaningful tax reform legislation. The bill passed last year by the House of Representatives is a good start, but it is not a final product.

The Senate Finance Committee has begun consideration of tax reform, and the administration has pledged its full cooperation in improving the House legislation. Our major desired changes include full $2,000 personal exemptions for both itemizers and nonitemizers, at least for lower- and middle-income taxpayers; provision of capital cost recovery allowances adequate to promote economic growth, and the protection of those allowances against inflation; and a top tax rate no higher than 35 percent.

Mr. Chairman, tax reform remains a top-priority item on the President's agenda. We will work in a bipartisan spirit to achieve meaningful tax reform this year. But let me be very clear that the President will not compromise on matters of principle, and he will not permit tax reform to degenerate into a tax increase in disguise.

Thank you very much, Mr. Chairman.

Chairman **Domenici**. Thank you, Mr. Secretary.

[The prepared statement by Secretary Baker follows:]

Testimony of The Honorable James A. Baker, III
Secretary of the Treasury
Before the
Senate Budget Committee
February 18, 1986

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the state of the economy and the new budgetary path. The major economic objectives of the Administration have been described by President Reagan in his State of the Union Message. Further details on this year's economic and budgetary outlook have been provided in the President's Budget and Economic Report. My remarks are an overview of the current situation.

We seek to build on the foundation of the solid economic performance that has already taken place. The current economic expansion has now moved into its fourth year and shows few signs of slackening. Growth was relatively slow at some times during 1985, but by year-end the economy was gaining momentum.

Some favorable features of last year's economic performance deserve at least passing mention.

- Consumer price inflation at 3.8 percent remained in the 3.8 to 4 percent range for the fourth year in a row. A table attached to my prepared statement shows the steady progress that has been made since 1980 when all of the measures of price performance were rising in the double-digit range.

- Employment has risen strongly in the current expansion, by over 9-1/2 million people. The unemployment rate has been reduced to below 7 percent and further progress is expected. The U.S. economy continues to display great job-creating ability.

- Last year's financial market performance was also encouraging. Record amounts of credit flowed to private borrowers, despite the persistence of large Federal budget deficits. Short-term interest rates are down on average by about 1/2 percentage point in the past year while many of the long-term rates are down by about two percentage points. The prime rate is down to 9-1/2 percent, the lowest rate in 7 years. Ideally, we would like to have seen interest rates come down even further than they have.

All of this added up to a year of solid economic performance in 1985. The latest economic information is generally favorable. Employment rose sharply in January and the unemployment rate fell. Other statistics have not been quite as strong but the year is off to a good start. The stage has been set for sustained expansion in output, jobs and income.

Sustained economic expansion is one of the most important prerequisites for improving the budget picture, as well as the financial security of the American people. During the current expansion, strong economic growth has been achieved in a much less inflationary environment than in the late 1970's. We must strive to extend that good record into the future.

The Administration forecast calls for 4 percent real growth during the four quarters of 1986. This would seem to be a reasonable expectation. The consensus private forecast has been a little lower, around 3 percent. But the recent economic numbers are causing some upward adjustment in the private forecasts. Those of us who advise the President on these matters feel that the current Administration projections are inherently reasonable although we also recognize that economic forecasting is at best an uncertain art.

The inflation outlook is also relatively promising, although the fall in the external value of the dollar will eventually begin to exert a little upward pressure.

The Federal Reserve obviously needs to remain alert to the needs of both the domestic and international financial situations. While they never lack for critics and there is always room for disagreement on the wisdom of some of their specific actions, it seems to me that the Federal Reserve has been doing a good job recently.

* * *

I would like to turn briefly now to the influence of the international economy on our own economic and fiscal situation. As a result of intensified efforts at promoting a favorable convergence of economic performance among the major industrial countries we have seen some improvement in the world economy. We expect to build on the progress this year. On balance, we expect stronger European and LDC domestic demand growth this year as they continue the process of shifting from export-led to domestic-led growth. Unfortunately there may be some weakening in Japanese growth as the previous stimulus from the trade sector is sharply reduced.

Exchange markets have recognized these generally favorable developments. The decline of the dollar since its peak last winter has been substantial. The yen is at a seven-year high against the dollar. Well over half of the dollar's rise on a real trade-weighted basis against other industrial countries from the end of 1980 to last winter's peaks has been reversed. This is good news for U.S. industry and agriculture. The U.S. trade deficit is likely to level off later this year. These developments should contribute to a more sustainable medium-term pattern of trade and current account balances. The G-5 meeting last September contributed to these developments. Our recent meeting in London showed that all countries were working to continue efforts for sustainable growth.

Another favorable development has been the downward movement in world petroleum prices. Although not without its costs, on balance this should strengthen growth and lower inflation in most of the world. A few countries and firms will experience problems, but with the U.S. debt initiative and a strongly growing world economy these problems can be handled.

While the international debt situation has continued to improve, economic growth in many debtor countries has remained unsatisfactory, and requires greater emphasis on structural policy reforms within those nations, buttressed by additional international financial support. As you know, the United States proposed last October at Seoul, Korea a "Program for Sustained Growth", involving mutually reinforcing actions by the debtor countries, the international financial institutions, and the commercial banks. The response has been very encouraging, with broad statements of support from the major bank groups in the U.S. and other key creditor nations, from the multilateral institutions and in principle from many of the debtor nations.

* * *

There are two major items on this year's fiscal agenda: deficit reduction and tax reform.

The President's budget for fiscal 1987 provides a detailed plan, satisfying the requirements of the Gramm-Rudman-Hollings legislation, by which a balanced budget can be achieved by fiscal 1991. The large budget deficits that we currently face are due to excessive Federal spending. Certainly it is not because the American people are undertaxed. As shown in the chart attached to my prepared testimony, receipts are running a bit above the long run historical average as a share of GNP. Despite frequent claims to the contrary, the 1981 Reagan tax cuts are not responsible for our current fiscal difficulties.

Our problems are on the outlay side of the budget, and that is where the corrective action needs to be taken. It would seem that Congress shares this view and is serious about cutting growth in spending. Outlays will continue to grow in absolute terms along the path projected in the new budget, but the rate of advance will be reduced significantly. Between FY 1985 and FY 1991, nominal Federal outlays would rise on average about 3 percent per year. In the prior six-year period, 1979-1985, the rate of growth was about 11 percent per year. Along the path projected in the new budget, Federal outlays would decline steadily as a ratio to GNP from 24 percent in 1985 to about 19 percent in 1991.

Receipts will be growing strongly in absolute terms as the economy itself grows, but receipts would remain close to a 19 percent ratio to GNP -- slightly above historical experience. Receipts are projected to rise by about an average 7-1/2 percent annually between FY 1985 and FY 1991, close to the 8 percent rise averaged in the previous 6 year period. With receipts growing normally and outlay growth restrained to a lower path, the budget will move into balance by 1991.

The reduction in the growth of expenditure required to balance the budget by fiscal year 1991 will not be easy, but the effort deserves strong bipartisan support. It can be done the hard, crude way, via sequestration across the board. Or it can be can be done more rationally and selectively, with respect for appropriate priorities. The President's budget is carefully drawn to meet the Gramm-Rudman-Hollings targets while preserving essential programs of the highest national priority.

The only alternatives to the domestic spending cuts emphasized in the President's budget are to raise taxes, to lower defense spending, or to cut social security benefits, none of which are acceptable. There should be no illusion that tax increases will somehow provide an easy way out. The President has expressed his views on this issue very clearly. He is firmly opposed to damaging the economy by increasing taxes. Defense, which is the most essential duty of the Federal Government, must be maintained. So must the social safety net, including social security and entitlement programs for the needy.

The outlay reductions would be expected to bring down interest rates with a beneficial impact on the entire economy. In addition, lower interest rates and a declining budget deficit will moderate the rapid rise in interest expense that has developed. This will free up funds for growth in essential programs.

The time has come to reduce what has clearly become an excessive rate of growth in Federal spending and to move toward a balanced Federal budget.

* * *

Our other major domestic policy priority is to achieve meaningful tax reform legislation. The bill passed last year by the House of Representatives is a good start but not a final product. Our primary concerns are the following:

- the bill lowers marginal tax rates but the top individual rate of 38 percent and the corporate rate of 36 percent are still too high;
- the bill raises the personal exemption to $2000, but to only $1500 for taxpayers who itemize deductions;
- the bill fails to maintain the cost of capital at sufficiently low levels to promote economic growth.

The Senate Finance Committee has begun consideration of tax reform and the Administration has pledged its full cooperation in improving the House legislation. Our major desired changes include:

- full $2000 personal exemptions for both itemizers and nonitemizers, at least for lower and middle-income taxpayers;
- provision of adequate capital cost recovery allowances and the protection of those allowances against inflation;
- a top tax rate no higher than 35 percent.

Tax reform remains a top priority item on the President's agenda. We will work in a bipartisan spirit to achieve meaningful tax reform this year. But let me be very clear that the President will not compromise on matters of principle and he will not permit tax reform to degenerate into a tax increase in disguise.

Conclusions

The U.S. economy turned in a solid showing last year and the outlook this year is for stronger real growth without much increase in inflation. Internationally, as well, there was progress during 1985 and we will be working to build on that foundation. Our major domestic agenda items are reduction of an excessive rate of growth in Federal spending as we move toward a balanced budget, and meaningful tax reform for the American people. We think that both of these efforts deserve and will receive strong bipartisan support.

RECENT PROGRESS AGAINST INFLATION

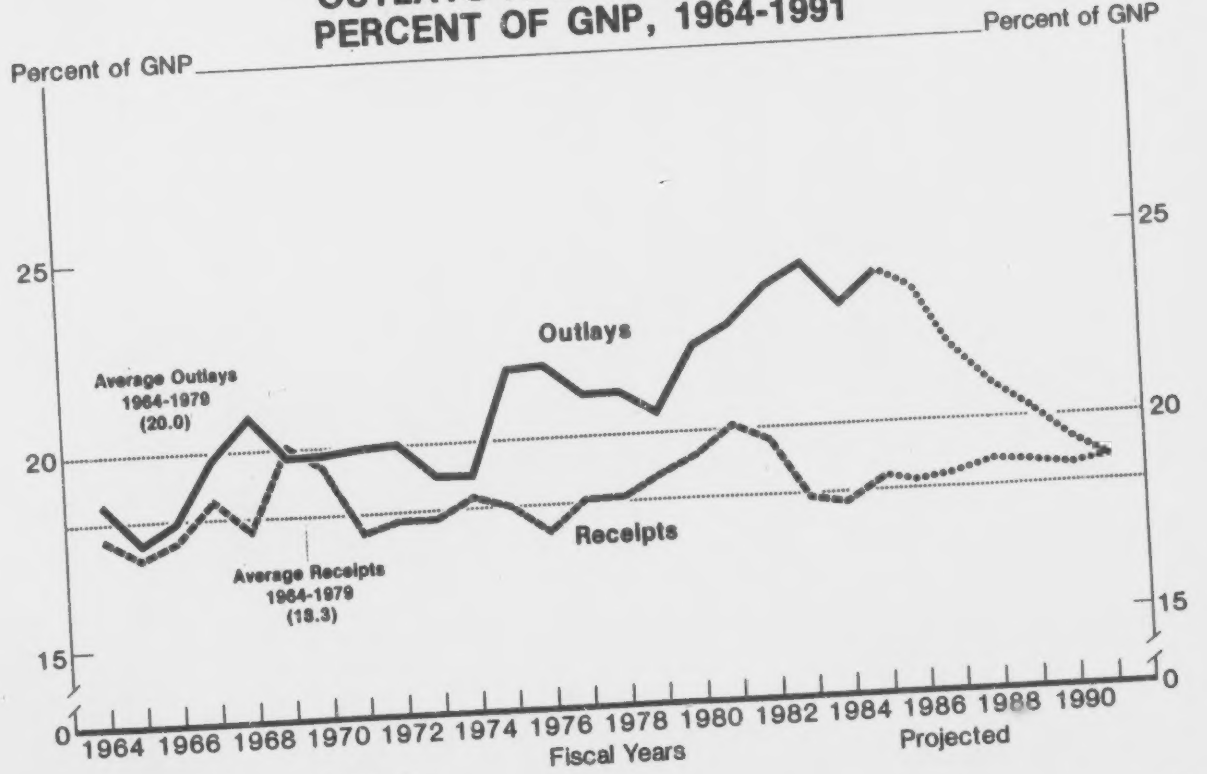
(percent change, annual rate, during period indicated)

	1980	1981	1982	1983	1984	1985
GNP: Implicit price deflator	9.9	8.7	5.2	3.5	4.1	3.1
Fixed-weighted basis	9.8	8.5	5.0	3.8	4.2	3.5
Consumer price index	12.4	8.9	3.9	3.8	4.0	3.8
Producer price index (wholesale prices)	11.8	7.1	3.7	0.6	1.7	1.8

Note: Fourth quarter to fourth quarter for GNP deflator, December to December for CPI and PPI.

January 30, 1986 A41

OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1991



Note: Outlays include off-budget federal entities.

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CAN PRESIDENT'S PLAN REACH GOAL UNALTERED

Chairman DOMENICI. You are aware of the position that the President announced, which you have endorsed here today, that we can get to the $144 billion with domestic cuts, not touching Social Security, not raising taxes, and increasing defense in real terms about 8 percent.

What if, instead of needing $37 billion to do that, the truth of the matter is that you need $53 billion in outlay cuts to do what the President wants in his budget—can you do all that with cuts on the domestic side, with the exceptions and exclusions that are inherent in the President's budget?

Secretary BAKER. Well, Mr. Chairman, it would be very difficult if you had to get $53 billion in savings just from domestic program spending. I have a slight disagreement with you, when you say it requires $37 billion. I think it requires about $23 billion, of domestic program spending reductions, to enact the President's budget. And of course, if his budget is enacted without any further policy changes, we will be in balance by 1991, if we are willing to bite the bullet this year.

Chairman DOMENICI. Make it as broad as you would like. His $37 billion is arrived at by domestic cuts, user fees, and some small revenue such as the cigarette tax.

Secretary BAKER. About $6.3 billion in revenues, Mr. Chairman.

Chairman DOMENICI. Well, not $6.3 billion in new revenues from new taxes.

Secretary BAKER. $1.7 billion in cigarette taxes; some user fees; $1 billion roughly in Federal employee retirement contributions.

Chairman DOMENICI. Right.

Secretary BAKER. So I guess my only point is there are $6.3 billion in revenue increases; there are roughly $5 billion in asset sales and interest saving; there are roughly $2.7 billion in defense reductions. So the domestic spending program reductions I really believe only total about $23 billion—if you assume that our figures are correct.

Chairman DOMENICI. I know a number of those things cannot be done and that has been my point. I do not think we can get the user fees through up here. I think you all know we cannot; we have never been able to do it. There is a serious question about the sale of assets. But let us assume we could do all those. My question to you based on your experience is, if in order to give the President his defense increase, we need on top of everything he has told us, we need $14 billion more in outlays, can we get it all without touching taxes, without touching Social Security. Can we get all the savings on the domestic side of the budget? Can we?

Secretary BAKER. Well, you have already said we cannot get $23 billion?

Chairman DOMENICI. Well, but you say we can get $37 billion, if it is made up your way. I am just adding $14 billion to it, because I think $14 billion is the realistic add-on.

Secretary BAKER. It would make it a lot tougher, clearly, Senator. But you know, we got $35 billion in 1981, thanks to your leadership. And we have not been able to do anywhere close to as good in any year since then. I really think we are only talking about $23 billion.

REACHING SPENDING GOAL AIN'T THAT EASY

Chairman **DOMENICI**. Actually, I believe everyone is running around saying this ought to be easy this year; after all, we have got the sustained growth, and it looks like interest is improving, especially if we believe Gramm-Rudman is going to happen. But the truth of the matter is, if the necessary reduction is anything like $51 billion to $53 billion, which I think it is at the minimum—if we are going to give the President his defense number—then it appears to me that that is the largest deficit reduction package in the history of the republic in 1 year, and people are running around, talking about it being an easy kind of job.

It is not going to be easy, and all you advising the President on whether we will negotiate ought to know that it is very, very difficult.

I will tell you one other thing. You understand baselines. As a matter of fact, I compliment you for your understanding in the past. You were aware that these huge outyear defense requests of 8, 9, 10 percent real growth year after year that were sent down here caused us to build in baselines that were incredible, because once we had approved 6½ percent, it was in there.

For your information, from those original add-ons to today's CBO baseline, there is a diminution, a reduction, of $290 billion in budget authority for defense just in that small period of time.

Secretary **BAKER**. Over a period of 5 years.

Chairman **DOMENICI**. Over a period of 5 years. But let me tell you, in addition to a cut of $51 billion to $53 billion being the biggest deficit package in history, the baseline from which we take it is probably the most lean baseline we have ever had. You know why—because it starts with Gramm-Rudman sequestered and only adds inflation. You know we have got to add in some areas. Some of your departments need money because the arbitrary cut did not work–for the IRS and for a number of other agencies.

So it is going to be difficult, and it is in that context that I urge that we attempt to negotiate an agreement and get this thing done.

OIL IMPORT FEE

Now let me ask you, is it your position as an advisor to the President that if the country were to have to use an oil import fee of $5 or $10, with a counterpart on refined products, is it your position that to use that in tax reform would not be detrimental to the American macroeconomy, but to consider it as part of deficit reduction would be?

Secretary **BAKER**. Well, I think the difference is, Mr. Chairman, if you use it in a revenue-neutral tax reform package, you are not increasing the tax burden on the economy by $1. You are shifting it a little, but you are not increasing it. If you use it for deficit reduction, you are increasing the overall tax charge against the economy.

Chairman **DOMENICI**. I understand.

Secretary **Baker**. But I do want to say one thing about the oil import fee. A lot has been written and speculated about that. All the President has said is that he would not close the door on that as a source of revenue in a revenue-neutral tax reform package.

GROWTH PROPOSAL WOULD NEGATE TAX INCREASE

Chairman **Domenici**. Now, Mr. Secretary, this is a preface to my last question. You know that when people ask me the question, are you for new taxes now, Senator Domenici, they are startled, because of what has been written about me, when I say "No." The reason that my answer is "No," is that I am for a budget reduction package that gets us to $144 billion with certainty, and I have contended that there must be domestic restraint with cuts and reforms, some defense reduction over the maximum request, and some revenue or taxes to glue it together. If that is a statement that I am for new taxes, the answer to that is "Yes."

Are you telling us that you are certain that switching taxes around as much as $110 billion under your plan is good for the economy, but that $15 billion in new revenues to put together a budget package is detrimental?

Secretary **Baker**. All I am saying, Mr. Chairman, is that we have got studies——

Chairman **Domenici**. Wait 1 minute, now——

Secretary **Baker** [continuing]. Both Treasury Department and CEA studies—that show that the tax proposal that we originally introduced would increase growth over the long term. We do not use those numbers because we do not want to be accused of——

Chairman **Domenici**. Yes, but Mr. Secretary, that is not my point. You can come here and say it is the President's absolute philosophical position that there will be no revenues in this package; that is fine.

Secretary **Baker**. That is his position.

EFFECT OF TAX INCREASE ON GROWTH

Chairman **Domenici**. That is his position. You represent him, and he is the President of the United States.

I am not asking you that. I am asking you if you, with your economic background and as Secretary of the Treasury, are telling this committee that it would be bad for the American economy, cause some kind of reversal of the positive growth that is occurring, if this Congress had to put $15 to $20 billion of revenue in a $50 to $60 billion deficit reduction package.

Secretary **Baker**. No, sir, I am not suggesting that, Mr. Chairman. What I would suggest is that it would be worse to do it in a way that would increase the tax charge on the economy overall than it would be to do it in a way that was totally revenue neutral. And I am not suggesting it is catastrophic, or that it is going to reverse growth, when you are talking about figures of the magnitude you are talking about.

Chairman **Domenici**. I thank you.

Senator Grassley.

DEFENSE INCREASE WITHOUT TAX INCREASE

Senator **Grassley**. Secretary Baker, what rationale would you offer in opposition to those who say we need a tax increase to pay for higher defense spending?

Secretary **Baker**. Well, Senator, I guess what I would say is that taxes as a percentage of GNP are as high as they have been on average over the course of our recent national experience. We are taxing the American people at roughly 19 percent of gross national product. We are not undertaxed. The fact of the matter is, we are overspending.

Now, you can have a debate about whether that overspending is occurring domestically, or whether it is occurring in the defense area. But the fact of the matter is, spending has gone up to 24 percent of GNP; taxes are level at about 19 percent, just above where they have historically been.

Senator **Grassley**. Are we overspending in defense?

Secretary **Baker**. I think we are overspending as a government. The big debate is with respect to where the overspending is occurring. The President certainly does not think we are overspending in defense. The President agreed last year in the Congressional Budget resolution to take a $290 billion hit in defense over 5 years.

CHOICE BETWEEN TAX INCREASES AND DEFENSE FREEZE

Senator **Grassley**. If it came down to a choice of either freezing defense expenditures or increasing taxes, which do you think the administration would opt for?

Secretary **Baker**. I would not hypothesize about that. The President made two promises in 1980, Senator. One was to increase America's defenses, and the other was to resist tax increases and give the American people a tax reduction, both of which he is trying very hard to follow through on.

Senator **Grassley**. Well, it seems to me like we could have the best of both worlds. We could freeze defense expenditures with no tax increase.

Secretary **Baker**. Except for the fact that the President would disagree with you. As Commander-in-Chief, I think he thinks that if you froze defense expenditures, you would be jeopardizing the national security of the country.

PROPOSALS WILL HEAD TO ECONOMIC DOWNTURN

Senator **Grassley**. Let me go on to another question. In your presentation as well as your printed statement, you put in a pitch for the tax reform proposal of the President. As a member of the Finance Committee, I sat through 7 or 8 days of hearings—since the President's message—on what is good and what is bad about that, from well-respected economists. And I think without exception—I'm referring to those people we have heard from so far, and I think we are done hearing in that area—they all project that the President's program, because of its lack of capital formation incentives, is going to lead to a downturn in the economy right away, very short term, and that would impact the fiscal year you are projecting here.

Secretary Baker. Senator, I think you were attending hearings with respect to H.R. 3838, which is the tax reform proposal that passed the House. And I would not argue with that conclusion. That is a bill that the President has said he will not sign. He would like to see the Senate Finance Committee and the Senate improve upon it substantially and particularly in the capital formation area.

Senator Grassley. Yes; but he wants that done without a tax increase offsetting capital formation costs, and you know, you are talking, I think, about $35 to $40 billion for some of the things the President says he wants.

Secretary Baker. Yes, but he has agreed to leave the door open with respect to energy taxes or a combination thereof, as far as a new revenue source is concerned.

Chairman Domenici. Excuse me. Would the Senator yield?

Senator Grassley. Yes.

Chairman Domenici. I thought that was much less than that; I thought that he would look at it, or it might be looked at. You are saying that——

Secretary Baker. What I am saying is he agreed not to close the door on consideration of energy taxes as part of a revenue-neutral tax reform bill.

Chairman Domenici. Go ahead, Senator.

DIFFERENT GROWTH PROJECTIONS

Senator Grassley. And your projection of 4-percent growth for the gross national product for next year brings in X number of dollars of revenue—and I do not have that in mind, and it does not matter——

Secretary Baker. $850 billion in fiscal year 1987.

Senator Grassley. OK. For the purpose of my question, the Congressional Budget Office testified this morning that they are projecting a 3-percent growth in gross national product, with about the same amount of revenue coming in.

Now, what difference is there between your projection of 4-percent growth and that amount of revenue that you would not end up with, and the higher amount of revenue coming in for what the Congressional Budget Office says we will get with 3-percent growth?

Secretary Baker. I am not that familiar with what the CBO revenue estimate is, Senator. I understand that testimony was taken this morning. But I thought that there was less of a difference between it than you suggest. I thought that they anticipated three point something——

Senator Lautenberg. In 1987, but 1988 was the difference.

Secretary Baker. It is 1986 when their estimate is very close to ours.

Senator Grassley. Are you sure of that? I was referring to Roman numeral XVII of the report put out this morning by the CBO.

Senator Lautenberg. It was 3.7 for 1987, and 3 for 1988——

Senator Grassley. OK. Well, then, I have to stand corrected. I am sorry.

I think it would be valuable for the record, though, if I could have your determination of the difference in growth. You come out with about the same amount of revenue, but you are projecting a higher growth than does CBO.

Secretary **Baker**. Yes.

Senator **Grassley**. OK.

Secretary **Baker**. Not much, though, for 1986.

[The following was subsequently supplied for the record by Secretary Baker:]

OMB VS. CBO REVENUES

The $850 billion I cited earlier referred to receipts for Fiscal Year 1987 under Administration policies. Your question seems to apply to current service receipts for Fiscal Year 1987 that both we and the CBO estimate to be $844 billion.

On a calendar year basis, the Administration forecasts real growth for the years 1986 through 1988 to be 3.4 percent, 4.0 percent, and 4.0 percent, respectively. For these same years the CBO expects real growth to be 3.2 percent, 3.1 percent and 3.3 percent. However, on a nominal basis, which is more relevant for analyzing tax collections, the Administration projects GNP growth to be 7.0 percent, 8.3 percent, and 7.9 percent for Calendar Years 1986 through 1988. The CBO projection for these three years of 6.9 percent, 7.3 percent and 7.6 percent is noticeably different only for 1987.

This difference in the forecast shows up as a difference in the current service receipts that we and the CBO anticipate for 1988, when our figure of $927 billion is $6 billion higher than their $921 billion estimate. The reason for this lagged reaction is that tax collections for Fiscal 1988 are largely determined by incomes earned in Calendar Year 1987, where we and the CBO have noticeably different forecasts of GNP growth. This is due to the fact that the fiscal year ends before the fourth quarter of the calendar year has begun and to the fact that taxes are generally paid somewhat after incomes are earned.

INTERNATIONAL DEBT SITUATION NOT GOOD

Senator **Grassley**. Lastly, I refer to your statement here about the international debt situation. With the falling oil prices, before fiscal year 1987 gets done with 18 months from now, the big banks are going to be in here asking for a rollover of that debt, and our Government backing that up through the International Monetary Fund. That is almost a foregone conclusion. It has got to be. You are going to be in here asking for money. You are proposing a very rosy picture here in the international debt situation that to me cannot be realistic in light of falling world oil prices and the problems for countries like Mexico, primarily, but also Nigeria, Venezuela, and other developing countries.

Secretary **Baker**. Well, again, Senator, I do not see that we are projecting a particularly rosy scenario for the international debt problem. It is a problem that we are trying to confront and deal with, but it is not rosy.

Senator **Grassley**. Well, it is a rosy scenario in the sense that you are projecting here that we'll get by without any help from the U.S. Treasury, as we did not get by in 1983 with the IMF bailout that we had.

Secretary **Baker**. Well, I cannot speak for 1983. I was not dealing with these issues then. But we have not asked for any money from the Congress by way of additional appropriations.

Senator **Grassley**. I know that; and I am asking how realistic is that that you are not, considering the seriousness of the problem that looms before us.

Secretary **Baker**. I think it is reasonably realistic, Senator. We have a rather detailed proposal out there relating to debt strategy. It is complicated to some degree with respect to certain nations as a consequence of the rapid fall off in oil prices over the course of the past 2 to 3 weeks. And the scenario certainly is not rosy with respect to many of those oil-exporting countries.

But we are not talking about bailing out any banks, and we are not talking about coming up here to you with our hat in our hand. The proposal does not contemplate that.

Senator **Grassley**. Well, I hope it does not, but I do not see how it can help but happen.

I would just make that point. Thank you, Mr. Chairman.

Chairman **Domenici**. Thank you, Senator Grassley.

Senator Chiles?

Senator **Chiles**. I will pass, Mr. Chairman.

HIGHER TAXES WOULD HAVE BEAT PRESIDENT

Chairman **Domenici**. Senator Lautenberg, before you start, let me just ask one question of the distinguished Secretary of the Treasury, who echoes the President's remarks and those who support him and say the President ran and won 49 States. The President was against taxes, and his opponent was for taxes. Have you run a poll to see how big he would have won if he was for taxes and Mondale was against them?

Secretary **Baker**. He would have lost.

Chairman **Domenici**. There is one out there that says he would have won 49 States, anyway.

Senator Lautenberg.

Senator **Lautenberg**. Your sotto voice, your soft voice, Mr. Secretary—would you repeat—I do not think the Chairman heard you. You said, "He would have lost." Is that right?

Secretary **Baker**. I think he would have lost.

Chairman **Domenici**. Oh, my.

Senator **Lautenberg**. OK. Just so the record reflects that. I owe my colleague from Iowa a correction before he leaves. I was 2 years off. It was 3.6 and 3 in 1986 and 1987, not 1987, 1988.

Senator **Grassley**. OK. I think I made the point in my question, and the Secretary is going to answer in writing. So if the answer is appropriate for 1987 as well as 1988, I would just amend my request to include 1987.

Senator **Lautenberg**. Mr. Chairman, thank you very much.

Mr. Secretary, I must tell you I have occasional problems with the language as it relates to where revenue goes. If it is for debt reduction, it represents an increase in taxes; if it is part of tax reform, it is not an increase. I think, that if we raise more money, we raise more money, and whatever the President's view is on that, I assume it would be fairly consistent.

TAX AMNESTY

I would like to ask you a question about something we discussed this morning, and that has to do with tax amnesty. On one hand, whether we collect uncollected taxes or whether we impose new taxes, we are taking money out of the economy. But on one hand, there is a difference in terms of the way we administer the code and the way we make requests of our citizens to bear their share.

Do you see any difference between whether we collect the funds out of new tax provisions or collect them from available sources under the existing code?

COLLECTING TAXES DUE HURTS ECONOMY

Secretary **BAKER**. I think if you can collect them from new sources, Senator Lautenberg, you are in effect again charging the economy with a greater tax burden than if you collect them through more effective enforcement.

Senator **LAUTENBERG**. So that you would support more active enforcement.

Secretary **BAKER**. Yes, sir, we do.

Senator **LAUTENBERG**. And you would not put a cap on how much you want to collect?

Secretary **BAKER**. No, sir.

Senator Lautenberg No, I mean, that tax is due. We ought to do our best to put it in the cash register.

Secretary **BAKER**. In fact, we have an initiative in the fiscal 1987, 1988 and 1989 budgets for the IRS designed to do just that.

Senator **LAUTENBERG**. I wanted to talk about that——

Chairman **DOMENICI**. Senator Lautenberg, would you yield to me for one moment?

Senator **LAUTENBERG**. Sure.

Chairman **DOMENICI**. I have to leave and make a call, and I am going to let Senator Chiles preside.

But I would suggest with reference to enforcement that you had better be careful as to how much money your initiative collects by way of taxes, because it would be very detrimental to the economy if you raise taxes.

Secretary **BAKER**. Not if they were taxes that were owed but not paid, Senator.

Chairman **DOMENICI**. Economists say there is absolutely no difference, but nonetheless, we are delighted that you are for some kind of revenue to put this package together. [Laughter.]

Secretary **BAKER**. Well, we are only talking about $4.7 billion there, Senator, so it is just a minimum assumption.

Senator **LAUTENBERG**. Well, there is some disagreement on that. Mr. Secretary, there are statements made that there is over $90 billion a year in tax avoidance that takes place.

Secretary **BAKER**. Yes, Senator, that is right.

Senator **LAUTENBERG**. I would think that a little skilled vigor on our part could improve collection of those outstanding sums. And I am, as I think you know, for a tax amnesty program that would invite individuals at a reduced risk to come forward and pay their old taxes. There are various estimates—I have seen some as high as $10 billion and some less—of what might be available. We have seen some very successful statewide programs in Illinois, Massachusetts, and New York. And I think that that is something we ought to consider.

Would you have any problems with that?

NO PROBLEM WITH TAX AMNESTY APPROACH

Secretary **Baker**. No, sir; in fact, we have agreed to do that. Senator Dixon has a bill along the same lines, and we have a study going on right now with respect to that.

The $4.7 billion figure I mentioned has nothing to do with the overall underground economy That is the amount by which we expect revenues to increase as a consequence of our 2,500-revenue-agent-per-year initiative. I just want to make that clear.

Senator **Lautenberg**. Mr. Secretary, you are then endorsing at least the review of amnesty—perhaps even an amnesty program?

Secretary **Baker**. Well, I would not want to go that far, Senator, or I would not want to go beyond what we have already agreed to do, which is to look into the question.

We have a study going on now between, our Tax Policy Office and the IRS, looking at that issue.

There has been some reluctance on the part of the Service to move in that direction because of the concern that it will, in fact, adversely affect enforcement in later years. The idea of voluntary compliance, in their view at least, has been historically very successful, and it might be jeopardized.

But nevertheless, we are actively looking at that, and we will continue to do so.

Senator **Lautenberg**. That is a matter for some debate and review, I mean, whether or not it affects future opportunities.

Secretary **Baker**. Yes, sir.

Senator **Lautenberg**. I see an amnesty as a way of getting more people on the tax rolls. I think that is a good idea. Again, based on the experience in various States, it looks like it is a can have a positive result. And no one can suggest that we are out to hurt anybody with this one.

Certainly, the pain would be a lot less for a State like mine than an oil import fee if that is the alternative. An oil import fee for us would not be a good thing at all. We in the Northeast use so much imported oil that if there were going to be any kind of a tax on energy, we certainly do not think that it ought to come in that form.

Secretary **Baker**. The thinking, I believe, Senator, is that a Federal Tax Amnesty Program might have some short-term benefits, but might have some long-term detriment in the sense that taxpayers would think that there was going to be more than one amnesty program.

So those are the things we are looking into.

Senator **Lautenberg**. Right, right. And I think the way to ensure that that will not take place, at least send a signal out there that this is not going to be a dispensation forever, is that we ought to really beef up IRS and the tax collection process. I know, Mr. Secretary, you did mention that there is a request for some additional funding. But based on the growth in the number of returns, both private and corporate, the numbers are almost staggering—some 180 to 190 million tax returns a year—and based on the request by the President in the new budget for 1987, I think we will be examining—for every 10,000 returns that are filed, we will be examining six additional returns. Well, I do not think that is enough if we are serious about getting additional revenue.

Mr. Secretary, we talk about revenues as a percentage of GNP as a fairly reliable index. We talk about expenditures relative to the growth of our economy, and based on what opportunities lie within our society. We try to develop tax policy and spending policy with that in mind.

AGGREGATE TAXES NEVER BEEN HIGHER

One of the things that I noticed in a Congressional Budget Office Report showing graphically income, revenues, over a period of some 35 years, was that as a percentage of GNP, individual income taxes in 1985 were actually at their low point. So it was with corporate income taxes, and I think corporate incomes have grown substantially in that period of time as a percentage of GNP.

What we see is the dedicated social insurance taxes, those that are growing at a much more rapid rate, but again, they are supposed to carry themselves.

So, what is the basis, Mr. Secretary, for denying the fact that our balance sheet or our financial statement has income as well as expenditures to be concerned with to deal with the deficit?

Secretary **Baker**. Well, clearly, you have got to look at both sides in figuring out what the deficit is going to be. But all I am suggesting, Senator, is that the overall receipts, whether they are dedicated taxes or the income tax, do constitute a charge on the economy, and they are at the levels that they have historically been in this country. Taken in the aggregate, they do not represent a cut from average past experience.

Senator **Lautenberg**. I see—and if anybody on your staff wants to disagree here—the chart shows about a 14-percent level. But if you look at this curve, you see that it is constantly on the downward trend, revenues by source as percentage of GNP. So we are now relatively speaking, at a low point, if you disregard social insurance revenues, which are specific revenues for specific programs.

Secretary **Baker**. Well, my figures show revenues as a percentage of GNP, as I indicated in my statement, of very close to 19 percent in fiscal year 1987—18.7 percent.

Senator **Lautenberg**. Is that exclusive of Social Security?

Secretary **Baker**. No; that is inclusive. Those are revenues in the aggregate.

Senator **Lautenberg**. OK. The point I want to make here is that focussing just on income taxes generally, individuals are paying lower——

Secretary **Baker**. I do not argue that point. Iam talking about taxes in the aggregate, all taxes.

Senator **Lautenberg**. Well, we are going to be working very hard in this Budget Committee and throughout this Senate to reduce expenditures in every way that we can. We are going to be reducing staff salaries substantially. We are going to be reducing operating budgets for various committees.

We are not cutting Senate or congressional salaries as part of this, which I think we ought to be looking at as well, if we are going to sacrifice for the good of this Nation and achieve budget deficit reduction.

CUTTING PERSONNEL IN INCOME PRODUCING AGENCIES

Mr. Secretary, in terms of our funding for Customs Service and other income-producing departments, are we kind of cutting off our nose to spite our face as we go along with these additional reductions in staffing, staffing in programs that produce a greater return in revenue than they impose in expense?

Secretary **Baker**. Well, I do not think we are, Senator. We are not cutting the staffing from our fiscal 1986 request, and I believe we are spending $1.8 billion for drug enforcement.

Senator **Lautenberg**. Well, we have a drop in Customs Service personnel. I know that my colleague, Senator Chiles, has an interest in this area. It shows a fairly significant drop in staffing in the 2 years.

I think also, as we look at the trade picture, it is not a very bright one, when we look at the deficit resulting from our imports. Isn't part of that very much a Customs Service function?

Secretary **Baker**. The trade deficit?

Senator **Lautenberg**. In making certain that products that are counterfeited and so forth are not brought into this country——

Secretary **Baker**. Yes, sir; that is right.

BLIND BUDGET CUTTING

Senator **Lautenberg**. So, as we examine the decision to cut across the board, I think what it is clear that we are not paying attention to priorities, to whether or not a program generates revenues or to the relative importance of one function over another. We are doing blind budget cutting that, in the final analysis, may be worse for us than better.

Secretary **Baker**. Well, you are suggesting if we get to automatic cuts.

Senator **Lautenberg**. If we get to automatic cuts.

Secretary **Baker**. Yes; well, you know, part of the Customs reductions that you are talking about occurred as a result of Gramm-Rudman, the first hit.

Senator **Lautenberg**. Right. And part of what the President is proposing as an alternative, Mr. Secretary, is something far worse, if the defense figures hold and the other domestic programs take their cuts, including these services we just——

Secretary **Baker**. Are you referring to what would happen in September?

Senator **Lautenberg**. Yes.

Secretary **Baker**. Sure, it would be worse; absolutely.

Senator **Lautenberg**. Thank you, Mr. Chairman.

Chairman **Domenici**. Senator Chiles.

SALE OF ASSETS

Senator **Chiles**. Mr. Secretary, when you were talking with Chairman Domenici, you suggested you would not need $38 billion in programmatic cuts, because the President's budget has user fees and asset sales proposals.

Given the fact that one of the reasons we are in this exercise is to try to reduce interest rates—and obviously, we are saying if the Federal Government does not have to borrow as much money, there will be more money in circulation, and interest rates would go down—how much are we going to reduce interest rates by the sale of assets? Somebody is going to have to borrow the money to buy those assets, are they not? And doesn't that take from that pool of money we are talking about?

So, while we get a temporary deficit reduction if we sell off the Grand Canyon—Disney might be interested in that; we are talking about that in Florida, and maybe making some interest. But they are going to have to borrow the money or arrange the capital some way to buy that, so it is not really going to give us any reduction in that interest rate figure, is it?

Secretary **Baker**. No, sir, and I do not think we ever suggested that that was what would be accomplished by asset sales.

ASSET SALES PART OF PLAN TO REACH TARGET

The asset sales in the President's budget are only $8½ billion over the next 3 years. But my only point, Senator Chiles, was that if you do not quarrel with our numbers—and maybe there is a legitimate basis to do that—but if you take the numbers in the President's budget, we really are talking about $23 billion in domestic program spending as the amount that has to be cut. If we just were willing to bite that bullet, we would put this deficit on a path to zero by 1991. And how do you get to $23 billion from $38 billion? You get there by taking out the roughly $5 billion of asset sales and interest savings, the $6 billion of revenue—20 percent of $38 billion is revenue increases of one sort or another—user fees, cigarette tax and take out the 2.7 billion for defense, and you get the $23 billion. That is roughly 5 percent of the $418 billion in domestic program spending (other that Social Security and interest payments).

Senator **Chiles**. So you would agree that we have already got some revenues in the quotient?

Secretary **Baker**. We have $6.3 billion.

Senator **Chiles**. So now we are no longer arguing over our profession, then; we are kind of haggling about the price?

Secretary **Baker**. Well, they are not new but they are in there. The biggest one is an extension of the cigarette tax. I think if we take a really close look at cutting spending—I realize it is difficult, and the chairman and I have spent 4 years talking about how tough these things are—but again, I would say if we could ever once do it, it would put the deficit on a path to zero, assuming our assumptions are right and if there was no increased spending in the interim. We would get to balance in 1991.

Senator **Chiles**. Well, the chairman has had a number of exercises and put the budget to zero, and the Senator from Florida has had a number of exercises to put it to zero. I can draw you up some more today, that if you just want to bite my bullet, it will go the same way, too. So it is a question of whose bullet we are going to bite, or whether we are going to take a fair share out of the bullet, or we are only going to bite off one side of it, or are we going to take a bite off the whole side.

MONETARY POLICY UNDER LOWER DEFICIT

A concern we have here is that the economic expansion continue while we achieve the lower deficit targets of Gramm-Rudman-Hollings. Iguess we are all hoping the Federal Reserve is going to take up some of the slack while we are waiting on the fiscal policy to come into effect, hoping it can sustain growth without planting the seeds of inflation.

Mr. Sprinkel, the Chairman of the Council of Economic Advisers, is counseling against monetary ease. In his Economic Report to the President, the Chairman states, "It is difficult to dismiss the inflationary threat that would be implied by persistence of the monetary growth rate experienced in 1985." He has warned of the inflationary dangers of current intervention.

I wonder if you could share your thoughts on what monetary policy you think should be under a regime of lower deficits. Do we need a cut in the discount rate? Do you believe the monetary growth of last year and the recent declines in interest rates are sufficient to give us the strong growth we need, or must the Federal Reserve be more aggressive?

Secretary BAKER. Well, Senator Chiles, I think, as I indicated in my statement, that the Federal Reserve has been doing a good job. It is their responsibility obviously to set monetary policy. I think that one of the conclusions you referred to in the Economic Report, was written before we saw the latest figures on the Producer Price Index, showing that it is down 0.7 percent. This would indicate that at least right now, we do not see an inflationary surge.

The Economic Report was also written before we had the tremendous decline in oil prices that we have seen over the past 3 to 4 weeks.

But be that as it may, it is my belief that we have no more important task, than continuing the fight against inflation. I remember in 1980 when inflation was 12.4 percent, and we were talking about how it was here to stay. Everybody was banking on it. Frankly, some of the dislocations that we see now in various sectors of our economy is a consequence of our finally getting inflation under control. It has been 4 percent or less for 4 years, and it would be tragic indeed if we lost that progress. I think that is one of the most significant accomplishments, if I may say so, of the President's first term.

So I would answer your question by saying the Federal Reserve is doing a good job. We have got to be alert to the dangers of inflation. I happen to be somewhat more eclectic, perhaps, in my approach to monetary policy than Beryl is. I think you ought to look at a wide range of factors, not just the growth in the money supply

But having said that, I agree with him 100 percent that we cannot afford to be less than vigilant in the fight against inflation.

CHANGES IN ANTITRUST LAWS NOT ANSWER

Senator **Chiles**. As you know, the Administration recently proposed several changes in our antitrust laws, claiming they were needed to meet the challenge of foreign competition. One proposal is to exempt from antitrust laws industries that have been seriously injured by imports.

I am not convinced that a relaxation of the antitrust standard is our answer. In many industries in which the foreign competition has been the most intense, our companies are already the largest in the world—auto, steel, electronics. Compare our three auto companies to Japan's nine. In the last several years, Congress has enacted laws which allow the companies to share innovative research, product development, and allow them to pool some of their export efforts.

But that seems to be a long ways from the notion that just bigness per se will restore competitiveness.

Don't you agree that we need to focus on particular problems raised by intense foreign competition and deal with those in specific and concrete terms, rather than just hoping a wholesale relaxation of antitrust laws allowing the big to eat the small are going to cure our trade problem.

Secretary **Baker**. I do not disagree with that, Senator. I do think that antitrust laws are one factor in the equation. I think you ought to look at the degree to which laws that have been on the books a long, long time might tend to make us noncompetitive. I think that is a valid exercise. I will say it is not unlike some of the complaints we have heard with respect to tax reform and international competitiveness.

It seems to me that what we do or do not do with respect to exchange rates can dwarf those other considerations when you start talking about international competitiveness. But I think it is perfectly appropriate to look at the antitrust laws and the possibility that there is an anticompetitive effect there.

LACK OF COMPETITIVENESS CAUSED BY INTEREST RATES

Senator **Chiles**. We all know the news that our trade deficit was nearly $150 billion in 1985. That tells us that we have been losing our competitive edge. The past couple of weeks, the Finance Committee has been looking on the impact of tax reform on the international competitiveness. We certainly need to have this debate; having complained so much about the level playing field because of the action of foreigners, we would be foolish to tilt the field against ourselves.

I also understand one of the major causes of our loss of competitiveness is the value of the dollar, which is related to our enormous deficits. If we are to restore our international competitiveness, we have to reduce the deficit.

I also understand the reason the cost of capital in our country is higher than abroad is not our tax system. Relative to our trading partners, our business tax provisions are quite generous. The real problem is real interest rates in the United States are so much higher than abroad, and it does not appear that those interest rates can come down without reducing the deficit.

If that is true, would you agree that our international competitiveness demands that we consider tax and budget policy simultaneously? Wouldn't we be selling ourselves short of the successes of tax reform spell the doom of deficit reduction?

Secretary **Baker**. I am not sure which of those questions you want me to address first. I think that there is clearly some relationship between the deficit and the interest rates in this country. I do not necessarily think that there is an automatic relationship between the deficit and the strength of the dollar, because we have seen, as I indicated in my statement, the dollar come down significantly here over the past year, and there has not been a whole lot of progress on the deficit.

We are running a roughly $20 billion trade deficit with Canada, but it is not because we pay higher interest rates in this country. The Canadians have significantly higher interest rates than we do. So I do not think that it necessarily follows that that is a factor.

Do I think that we have to combine tax reform and deficit reduction? No; I think they can appropriately proceed on separate tracks, and I think it is probably best if they do. They have been proceeding on separate tracks for over a year now, and it does not seem to me it is an either/or situation, Senator Chiles. It seems to me that you can accomplish tax reform on a revenue-neutral basis and still have the necessary legislative and executive branch resources devoted to deficit reduction to accomplish that goal as well.

Senator **Chiles**. That is all.

Chairman **Domenici**. Thank you.

Senator Andrews.

Senator **Andrews**. Thank you, Mr. Chairman.

FLAP OVER MONEY SUPPLY COURSE

Mr. Secretary, it is good to see you here. Let me ask, it is fairly well known that there is some division within the administration about the proper course of action to take regarding the Nation's money supply. At a time when many of our farmers are facing dire economic circumstances, clearly one helpful change in Government policy would be to loosen money restraint slightly.

Could you comment on the course of action you would like to see the Government follow in this line?

Secretary **Baker**. Well, we would all like to see lower interest rates, Senator Andrews. There is no argument from anybody, I suppose, on that.

Senator **Andrews**. But when you look at farmers, you know, the cash-flow problems with agricultural loans are directly affected by the rate of interest.

Secretary **Baker**. That is right, and the same thing is true with respect to the international debt problem and energy loans and all the rest. But having said that we would all like to see lower interest rates, I would repeat what I said a moment ago—and perhaps it was just before you got here—that we should not take our eye off of the inflation ball. It would be a tragedy if we lost the gains that we have made against inflation. And my view is that the Federal Reserve has been doing a good job over the course——

Senator **Andrews**. That is true, Jim. But the one industry in our country where not inflation but deflation is holding sway is in the field of agriculture. Land values have dropped by 30 to 40, maybe 50 percent. Interest rates are really killing them because farmers have to borrow more per worker in agriculture than in any other industry.

Secretary **Baker**. All I am suggesting, Senator, is that it would not do, in my view, to trigger a resurgence of inflation. We would just start back out into these cycles that we used to go through all the time, and which we have fortunately avoided over the course of the past 4 years. And the one thing we cannot afford to do is start back down that trail.

One reason that I think that agriculture, and the energy sector as well, have tough times now is because there was so much inflation, and people learned to bank on it and rely on inflation. A lot of people were betting on $40-a-barrel oil and $1,000-per-acre land prices. You are right that deflation has caused considerable problems, but the answer is not to turn on the money spigot to lower interest rates.

INTEREST RATES NOT UNDER CONTROL

Senator **Andrews**. Well, we have got all the factors under control in this administration, really, with the exception of actual interest rates, and that is the thing that is killing our farmers

Secretary **Baker**. But the long-term rates are lower than they have been in quite some time.

Senator **Andrews**. In precise terms, perhaps, but in actual interest rates, interest rate versus inflation, it is higher than it has ever been, and that is the thing that is hurting the farmers.

HOW POLICY IMPACTS AGRICULTURAL EXPORTS

The other side of the agricultural economy, of course, is the fact that we have got to market three out of every five bushels of grain we produce overseas. You have spent a great deal of effort formulating a U.S. approach to these international monetary situations. In fact, the President endorsed your efforts in his State of the Union speech, and I applauded him for that.

I do not need to tell you the consequences of your actions are going to have a profound effect on the farmers and bankers and rural communities in my State and across the United States.

How would the reforms yo are now considering impact on our agricultural exports?

Secretary **Baker**. Well, I think that you should see some beneficial effect on agricultural exports as a consequence of the lower value of the dollar over the course of the past year.

Senator **Andrews**. Is your program to consistently try to get this dollar back to a more normal relationship vis-a-vis the other currencies?

Secretary **Baker**. Well, that was the goal of our September 22 meeting at the Plaza Hotel, and we are pleased with the progress that has been made in that regard thus far.

Senator **Andrews**. And do you think we can see more progress along that line?

Secretary BAKER. We would not be displeased provided that that progress was orderly and pursuant to normal market forces.

Senator ANDREWS. One of the big problems we have, Mr. Secretary, is holding out that lifeline of hope to those farm families that do not know which way to go. And if they feel that you, as Treasury Secretary and one of the most able members of this administration, are working in this direction, I think they will feel a lot more hope than they would feel otherwise. I think your reassurance would mean a good deal to them.

Secretary BAKER. Senator Andrews, unfortunately, it takes about 12 to 18 months for exchange rate changes to be seen in the trade numbers.

But let me just point out to you that the dollar has declined against the German mark 32.2 percent since this time last year, and against the Japanese yen——

Senator ANDREWS. That is almost the period of time since you have taken over as Treasury Secretary, Jim.

Secretary BAKER. Well, I do not know whether that is good or bad.

Senator ANDREWS. Well, I know we farmers salute you.

Secretary BAKER. Against the Japanese yen, it has declined 29.8 percent since this time last year. Since we had our meeting at the Plaza Hotel, it has declined 18 percent against the mark and 24 percent against the yen.

So we are making progress, Senator.

Senator ANDREWS. And what I can tell my farmers is that you applaud this movement, and you are looking for more movement in this same direction.

Secretary BAKER. I would like you to tell them that we hope that shortly—since since the decline started 1 year ago, and it takes 1 year to 18 months for it to be seen in the trade figures, hopefully we will start seeing it soon in the trade figures.

Senator ANDREWS. How much further do you expect it to decline this year?

Secretary BAKER. Well, I do not want to make a guesstimate on that Senator, because that is all it would be.

Senator ANDREWS. In the years I have served on this committee, everybody comes up with their estimates. I think you are probably a better estimator than many of the others we have listened to.

Secretary BAKER. Yes; but if I gave you an estimate, it would only be a guesstimate, and I ought to refrain from doing that.

INCOME APPROACH TO FARM SALES

Senator ANDREWS. Mr. Secretary, section 2032 of the Internal Revenue Code allows farmers and other closely held businesses a special election for valuing their real property at less than fair market value in their estates. The value used on estate tax returns is based on an income approach to valuation rather than fair market value. One of the key things that hits farmers is that their land is valued in their estate on the basis of what some "yo-yo" is willing to pay for the 80 acres adjacent to them, not on the basis of what it will produce in income.

If a farmer dies, it is not valued the same way as if a hardware store owner or an automobile dealership owner is moving on and passing the estate to his family. There, I think it is valued at about seven times earnings.

The purpose of the law is to help keep the family farms together by lowering estate taxes. There is a provision in the law that if a farm was ever sold and not used as a family enterprise, the Government could recoup the tax. Some farmers are now going through foreclosure proceedings because they do not have enough money to pay their debt against the land; yet this sale triggers, Mr. Secretary, the tax recapture, and normally, anything left after the sale of the land will be eaten up by the additional tax that is due, rather than go to pay the indebtedness by the farmer. It seems particularly cruel that the very provision that was meant to allow them to pass their farms on to their children is now used against them and leaves them no alternative but bankruptcy.

Does such a system seem just and fair to you?

Secretary **BAKER**. Well, without knowing anything about the particular section, Senator, it would seem to be somewhat unfair, if it was indeed an involuntary sale. If it was not a sale that was negotiated by the farmer/debtor, it would seem somewhat unfair.

Senator **ANDREWS**. Would you support a change in these regulations after study, if it does indeed——

Secretary **BAKER**. Is it a regulation or is it a statute? I thought you said it was a statute.

Senator **ANDREWS**. It is really a Federal statute, but we need your support to get the change in the statute, Mr. Secretary. It is all the same.

Let me put it this way, Mr. Chairman. Could you take a look at this, Mr. Secretary, and supply us a more extended response for the record, or perhaps drop me a line?

Secretary **BAKER**. Yes, Senator, we will.

[The following was subsequently supplied for the record by the Department of the Treasury:]

SPECIAL ESTATE TAX BENEFIT

A—The purpose of section 2032A is to provide a special estate tax benefit when family farms and certain other closely held businesses are transferred by decedents to family members who continue to operate them. Exempting certain dispositions—such as foreclosures—from the recapture rule would thwart the statutory purpose of section 2032A and create the possibility of abuse. Such an exception would thwart the statutory purpose of section 2032A by extending the tax benefit to cases where the statutory purpose of section 2032A is not being met. Where the farm is not being retained and operated by the family, there is no policy reason to provide an estate tax benefit that is not available to other taxpayers. Moreover, such an exception would invite abusive tax planning. For example, an estate could elect section 2032A even though there is no intention to continue its operation as a farm, and then make a disguised sale of the farm by borrowing its fair market value on a nonrecourse basis from the purchaser, who would then acquire the property through a foreclosure rather than through a sale.

IMPACT OF TAX REFORM ON TEACHERS' RETIREMENT PROGRAM

Senator **ANDREWS**. Finally, Mr. Secretary, there is a provision in the House tax bill that would eliminate the tax-exempt status of the Teachers Insurance and Annuity Association. Now, this would have an adverse impact on the pension benefits provided under

3,700 educational pension plans for 1 million current and retired educators.

I serve on another subcommittee that funds the Education Department, and one of our biggest challenges is to get adequate teachers into the field. Part of their compensation, of course, is their wages; part of their compensation is their retirement benefits that go down the line. They are not in private enterprise, and they are not building up liquidity in an estate, by virtue of being independent business people. All of TIA's assets support pension and related benefits for higher education and by charter and trust law cannot be diverted for any other purposes.

The bill as it emerged from the House, as I understand it, continues the tax exemption for virtually all other pension funds

Does the administration favor this change, which seems to be a detriment to the recruitment and keeping of able teachers?

Secretary BAKER. Senator, I will just have to take a look at that. I do not know whether that was in the Treasury-II proposal or not; I have no independent recollection of it.

Senator ANDREWS. If I could get your comments on that, I would appreciate it, for the record.

Secretary BAKER. Yes, sir; we will supply those for the record.

Senator ANDREWS. I would appreciate that for the record, Mr. Chairman, because we do not want to get you into a hasty answer. But given the singular purpose of this association to encourage the most competent educators to stay in the field of education, given the fact that TIA has a nonprofit status that has been connected with the education system, it seems to me highly unjustified to abandon a program that has been around for some 65 years. That is a rather sharp departure, and I would appreciate very much your candid appraisal of this.

Secretary BAKER. We will take a look at that. I do not know whether that came in with the administration blessing or whether it was just put in the House bill. I do not know whether it was in Treasury-II. We will find out for you.

But let me say this: if you are going to have fundamental tax reform, and if you are going to cut all those people's top rates by 15 percent, and you are going to double their personal exemptions, it is just like any other preference or deduction. You do not get the goody on this side unless you are willing to eliminate some of these preferences and deductions.

But we will take a look at it, Senator.

Senator ANDREWS. Mr. Secretary, I could not agree with you more. And as members of this committee know, I am the one who cosponsored the across-the-board freeze, which was rather tough, plus some revenue enhancement, as Fritz and I talk about, which I think also is necessary, because I agree with you totally that we have got to get these deficits under control. You and I have talked about this in the past.

The thing that bothers me about taking away the deduction of this institution that has been there for 65 years, targeted for educators, is the fact that the same bill leaves a whole host of other similar programs intact. Why the pension fund for educators—because it has been around for 65 years—is singled out, that is the question that I have.

Secretary **Baker**. Sure.

Senator **Andrews**. If we are doing it across-the-board, an across-the-board freeze is a totally different thing. But to zero in on this one, in face of the needs that the President has pointed out and all the rest of us know, of keeping quality educators in the system, I am concerned about it, and I would appreciate your candid appraisal.

Secretary **Baker**. We will get you an answer.

Senator **Andrews**. Thank you very much.

Thank you, Mr. Chairman.

Chairman **Domenici**. Thank you, Senator Andrews.

[The following was subsequently supplied for the record by the Department of the Treasury:]

TIAA TAX EXEMPTION

The Administration is currently studying whether it may be appropriate to eliminate the tax exemption of TIAA. TIAA is a nonprofit corporation engaged in the business of selling deferred annuity contracts (and, to a lesser extent, other insurance products) to employees of colleges, universities, and certain other nonprofit educational institutions. TIAA was organized in 1918 by the Carnegie Foundation for the Advancement of Teaching. Upon its organization and for many years thereafter, TIAA obtained much of its capital and surplus in the form of contributions from charitable foundations. Currently, however, TIAA charges its customers premiums in an amount sufficient to meet expenses and generate a profit.

The elimination of the tax exemption of TIAA reflects the judgment that the sale of insurance and annuity contracts is a commercial business rather than an inherently charitable activity. Under the House bill, unless the insurance and annuity contracts are provided at substantially below cost to a class of charitable recipients, this business would be subject to tax. TIAA would be unable to meet such a standard for tax exemption. The individual policyholders of TIAA are not a class of individuals in need of charitable assistance. Moreover, TIAA's insurance and annuity products are not provided substantially below cost. For example, in 1984, TIAA had a gain from operations, after policyholder dividends, of almost $160 million.

TIAA argues that it should remain tax-exempt because, in effect, it constitutes a multi-employer pension fund. TIAA further argues that the bill would have the effect of forcing educational institutions to form new multi-employer pensions funds or of forcing TIAA to restructure to provide pension benefits through separate accounts without annuity guarantees. It argues that these changes would be costly, would impair the retirement benefits of employees, and would raise no significant additional amounts of tax revenues.

On the other hand, there are very significant differences between TIAA and a multi-employer pension plan. TIAA is not currently subject to many of the rules applicable to pension plans, including minimum coverage and nondiscrimination rules, and TIAA opposes the extension of these rules to the annuity contracts it sells. It can be argued that TIAA is no more a multi-employer pension plan than any insurance company that sells deferred annuity contracts to individuals or provides investment and administrative services to qualified pension plans. In addition, TIAA carries on life insurance and accident and health insurance businesses that, although small in comparison to its annuity business, are large in absolute terms. For example, in 1984, TIAA's premium income from life insurance policies was over $66 million and its premium income from accident and health insurance policies was over $74 million.

The fact that TIAA sells annuity contracts in competition with commercial insurance companies must also be taken into account. Although TIAA is a nonprofit organization that will, eventually, distribute all of its income to policyholders in the form of policyholder dividends, this is true of any insurance company that is organized in mutual form. Many of the country's largest commercial life insurance companies are mutual organizations.

If TIAA's exemption were eliminated, it would be taxed as a life insurance company. Life insurance companies are allowed deductions for the payment of life insurance and annuity benefits and for the establishment of reserves for future liabilities under life insurance and annuity contracts. These deductions would offset any premium or investment income that is used or set aside for these purposes. Accordingly, even if TIAA becomes subject to tax, the annuities owned by TIAA's policyholders would continue to earn income that is not taxed currently, either to the policyholder or to TIAA. The only amount that would be taxed is the net income, as determined under the normal life insurance company tax rules, that is earned by TIAA. As is the case with commercial mutual life insurance companies, the fact that all or part of this net income is distributed, or held in reserve for future distribution, to policyholders would not prevent the taxation of the income.

TIAA has served a valuable role in making retirement annuities available at reasonable cost to employees of educational institutions. As is the case with many other tax reform proposals, the merits and probable consequences of the proposal to eliminate the tax exemption of TIAA are subject to debate. In formulating our position in this debate, we intend to give full consideration to the retirement needs of the employees served by TIAA.

Chairman DOMENICI. Senator Andrews, Senator Quayle, I wonder if you could accommodate and chair for 10 to 15 minutes. I have to leave at that point for the White House.

Senator QUAYLE. I have just one question that I have been waiting about one-half hour to ask, and then I must get back to the Armed Services Committee where we are marking up a military reorganization bill.

Chairman DOMENICI. All right. Why don't you ask it, and I will stay here for a bit.

Senator Andrews, can you stay?

Senator ANDREWS. Sure.

You get down to the White House, Mr. Chairman.

Chairman DOMENICI. Well, I am not going down on this issue, not for a while. Give me about 10 days before I go.

GNP SPENDING PERCENTAGES MAY NOT BE RELEVENT

Mr. Secretary, let me just make one point. I wish you would look, when you make statements about the level of taxation in the country—I agree with you that the 19-percent tax, from the macro standpoint, on our gross national product is kind of consistent with some reasonably good times for a long period of time. But I think there is a startling number. Domestic programs to help lift our senior citizens out of poverty have succeeded admirably. Over 15 years, we went from 10 or 15 percent that were not in poverty, and 85 percent that were to the reverse. But there is a startling number in terms of the percentage of the tax take that goes to social insurance taxes and the related contributions.

I would just give you two numbers. In 1970, the percentage of the tax take that went to these programs was 23 percent; in 1986, it is 36.1 percent.

I think that merely points up how tough it is to try to pay for an increase in defense and for some domestic programs that are not senior citizen-oriented, and come up with some kind of a number like 19 percent and make it empirically binding in terms across the board.

One other point that I would like to make in that regard is for those who say that ultimately, social security should come off the unified budget, as some have said including the President, that disparity points up what will happen to the deficit.

Secretary BAKER. That is right.

Chairman DOMENICI. I mean, it will be billions of dollars that are in the Treasury because we taxed the people, but you cannot balance it against other expenditures, even for the macro-economic look at how much taxes are in disparity from things we are paying for. That would mean, in my opinion, you would not be able to pay for anything in about 9 or 10 years, from defense on down; you would have to put everything at 30 to 40 percent.

So I think somebody ought to get that point across. It is not the trust fund. It is the notion that they are all taxes, as you have indicated, and if there are excesses and abundance there—and there are—you have got to use them to pay the deficit. Otherwise you will not have very many programs, or will have to raise taxes to an incredibly high level.

Secretary **Baker**. I understand that, Mr. Chairman. You know, Senator Grassley asked a moment ago aren't we willing to pay for the increase in the level of defense expenditures. I think it is noteworthy to take cognizance of the fact that defense as a percentage of GNP is lower than it was in any peacetime year under John Kennedy or Lyndon Johnson. It is roughly 6 percent, as you know; I would simply like the record to reflect that, because it is not a case of our going out and spending as a percentage of GNP an incredible amount on defense. Now, we can argue whether that is the right amount with respect to what we are spending on some of our domestic programs, but nevertheless——

Chairman **Domenici**. I think, though, Mr. Secretary, on the other hand, the facts that I just gave you are also relevant.

Secretary **Baker**. They absolutely are.

Chairman **Domenici**. As to whether the 6.2 historic level of defense is totally relevant to the distribution of resources, it may not be so relevant as it was 15 years ago.

Thank you very much.

[Whereupon, Senator Andrews assumed the Chair.]

Senator **Andrews** [presiding]. Senator Quayle?

Senator **Quayle**. I might just add to that discussion that not only are we spending less as a percentage of gross national product on defense than under the peacetime budgets of both Kennedy and Johnson, but the world today is far more threatening than at those particular times, yet we are still spending less on a percentage basis.

Secretary **Baker**. That is right.

Senator **Quayle**. So I take exception, really, to the notion that we are going to balance the budget somehow by just cutting defense without putting our country at undue risk.

INDEXING TREASURY BONDS

Mr. Secretary, welcome back. The issue that I want to explore with you is the possibility and idea of long-term Treasury Bonds indexed for inflation.

If, in fact, this would work as many envision it would be a very strong commitment and incentive on the part of the Government to hold down the inflation rate—which you have said a couple times here today that you want to pursue keeping inflation in check with a vigilance, and I certainly support you in that respect—through indexed Treasury bonds, we would also have the possibility of saving some moneys in interest payments on the national debt. You know, when you look at the budget, people say you cannot save any money in the area of national debt, that we have to pay the interest—yes, we do have to pay interest, but what interest rate are we going to pay?

Those who are experienced with this, believe that if we are able to hold inflation down and thus bring people's expectations down, that maybe a real rate of return of, say, 2 or 3 percent over inflation would be a better way to pay interest rather than issuing long-term bonds with an average interest rate of 11 or 12 percent last year.

Have you given any thought to this? Do you see any merit to exploring, maybe on an experimental basis, indexing some of our national debt?

RESERVATION ABOUT INDEXING BONDS

Secretary **BAKER**. Senator Quayle, we are looking at that issue now. I have to tell you I have got some reservations with respect to whether it would help us control inflation or make it tougher to control.

There are a lot of countries that have indexed both sides of the balance sheet, and they have been sorry in retrospect that they did so. Israel, I think, has an economy that is highly indexed. Some of our neighbors to the south do. And it makes it awfully easy for inflation to feed upon itself when your debt securities are indexed.

We already have the authority to issue these. We do not need additional authority. We are taking a look at it. But I have to be honest with you and tell you there are some reservations.

BRITISH INDEXING EXPERIENCE

Senator **QUAYLE**. Are you familiar with the experience in Great Britain, which is probably more similar to our kind of economy than Israel or the South American countries that you mention?

Secretary **BAKER**. We are going to be talking to the British about that. We undertook this investigation only about 3 or so weeks ago. The British experience has so far been, I think, pretty good. But there have been others whose experience has not been as good.

Senator **QUAYLE**. I think you have to put all of data in the computer. But if you do look at the British experience, which a lot of people are referring to, I think you will find that Great Britain is in fact paying less now on their national debt, and that people are willing to accept a 2 percent or 3 percent return in real terms. In the past, we have always had a difference—historically around 3 or 4 percent—between the inflation rate and the interest rate. Its now about 5 or 6 percent, and has gotten up as high as 8 or 9 percent. I think if you look at the fact that there might be an anticipation of high inflation, indexing would lower interest rates. I do not think you want to get into a totally indexed society as you mentioned. There are a lot of problems with indexation, but there are some benefits too.

I would think that this might be one means, which would not cause incentives for inflation, that instead, it might just be the reverse. Indexing it would show a real strong commitment, to keep inflation low because the Government in this case would gain revenues by having policy of low inflation, whereas now, on the contrary, the Government gains in real terms by inflation, as the value of the debt is debased.

So I would think from that point of view, we might see a very strong commitment to low inflation rather than letting it get out of the bag.

Secretary **BAKER**. Well, we are taking a look at it, and we will continue to do so.

Senator **QUAYLE**. I look forward to working with you and others on this issue.

Thank you.

Senator **ANDREWS**. Thank you, Senator.

Senator Lautenberg?

Senator **LAUTENBERG**. Thank you, Mr. Chairman.

Mr. Secretary, I will not hold you much longer. I appreciate the chairman's indulgence and the cooperation of my colleague.

CUSTOMS SERVICE PERSONNEL DROP

We talked briefly before about the Customs Service staff, and we need, I am sure you agree, to enforce international trading agreements. But we are talking about a drop—though I think you said additional money may be available, the fact is that there would be a drop in staffing—from 14,000 in rough terms in 1986 fiscal year, to 12,500 in fiscal year 1987.

Secretary **BAKER**. Senator, it is a drop from 13,264 to about 12,500 full-time equivalents.

Senator **LAUTENBERG**. OK. So we have a drop of about 700 people—was I right on that arithmetic—did you say 14,000 to what?

Secretary **BAKER**. 13,264 to about 12,500.

Senator **LAUTENBERG**. Yes; roughly 900.

Secretary **BAKER**. Positions which were added in by the Congress over the President's budget request in fiscal 1986.

Senator **LAUTENBERG**. OK. But in a memo challenging these cuts, the Acting Commissioner of Customs said, and here I quote, "Because staffing levels may drop below minimal standards needed for compliance review, revenue collections will also drop."

You are aware of that. Do you agree with him that it may impair Customs selection?

Secretary **BAKER**. Well, I have no basis to disagree. [Conferring with staff.] We might disagree with the amount by which——

Senator **LAUTENBERG**. By which they will fall short.

Secretary **BAKER**. Yes.

Senator **LAUTENBERG**. But you are saying, therefore, that if you disagree with the amount, you do agree with the fact that we may be reducing the revenue collections from what they could be.

Secretary **BAKER**. That is possible, yes, sir. We do not think they will be anywhere near as great as Customs.

Senator **LAUTENBERG**. I would appreciate hearing from you as to what your projections are for any loss of revenue as a result of this cutback.

Secretary **BAKER**. All right.

[The following was subsequently supplied for the record by the Department of the Treasury:]

POTENTIAL LOSS OF CUSTOMS REVENUE

According to the Customs Service, there are no projected revenue losses in FY 1986 or FY 1987. The Customs Service is in fact projecting revenue increases. Revenue projected for FY 1986 is $13.9 billion, up 5.1 percent above FY 1985, and the $15.1 billion projected for FY 1987 represents an 8.6 percent rise. In previous analyses, the Customs Service concluded that other factors, including strength of the dollar, prices, trade, the international situation, etc., impact revenues more significantly than Customs staffing.

Furthermore, as you are aware, the Customs Service has been developing and implementing an Automated Commercial System (ACS), which is now processing entries of merchandise act duty collections. As a result, there have been substantial increases in productivity; automation has replaced traditional manual processing methods. Therefore, staffing reductions that may occur can be absorbed with minimal impact upon processing times or revenue.

TUITION TAX CREDITS INCONSISTENCY

Senator **LAUTENBERG**. Now, Mr. Secretary, I would like to go on to something else. I mentioned to you before that I am opposed to an oil import tax whether it is in tax reform or deficit reduction. But I am not opposed to revenue enhancement reduce the deficit. Now, let's look at the President's position, as I understand it. He is saying no new tax revenues unless they are traded for tax reductions, so the package comes out neutral.

The thing I do not understand is how the President does not object to adding new tax reductions outside tax reform; if a tax would cut the deficit, the President says no, it has to be neutralized. But if a tax incentive would increase the deficit, that seems to be a different story.

So we have tuition tax credits proposed. That would cost almost $2 billion over 3 years. We have a noble college savings incentive program that would cost half a billion.

Now, I do not want to argue the merits of these actions here, but aren't we looking at a double standard?

Secretary **BAKER**. I do not think it is a double standard, Senator. The tuition tax credit proposal is in the budget. It is estimated at $400 million in fiscal 1987.

Senator **LAUTENBERG**. We are saying $2 billion over 3 years, I think.

Secretary **BAKER**. I am not arguing with that. The only number I happen to have right here is the $400 million. I do not see why that is——

Senator **LAUTENBERG**. Well, isn't that the reverse of the coin that says we will not do any tax increases, we will not encourage or permit any tax increases that reduce the deficit. We want to hold that fast. But on the other hand, we are willing to increase the deficit by adding programs that result in less revenue.

Secretary **BAKER**. Well, I do not think that that can be properly characterized, if I may say so, as a double standard Tuition tax credits is a proposal that the President sent up here 2 or 3 years ago, and it has been in every budget since then. He is not adding any other revenue items that exacerbate the deficit that I am aware of.

Senator **LAUTENBERG**. But those credits reduce tax collections.

Secretary **Baker**. Well, that one proposal would, yes.

Senator **Lautenberg**. Also the college savings plan.

Secretary **Baker**. Yes; those are both things that have been in his budgets for quite some time.

Senator **Lautenberg**. No; my observation is that the President is more amenable to provisions that add to the deficit that way than——

Secretary **Baker**. Senator, those provisions were in the President's budget when he went for the tax bill of 1984, and I think even when he went for TEFRA.

Senator **Lautenberg**. Mr. Secretary, in all fairness, the fact that it is old does not change it. What has changed is the situation we are in. We are talking about deficit reduction, and this looks like a way to increase the deficit.

SUPERFUND OVER ADMINISTRATION'S VIEW

I wanted to ask you one other thing. On Superfund, the President's budget for Superfund provides slightly over $1 billion in budget authority for fiscal 1987. That is a figure that has been consistent with the administration's view for a $5.3 billion, 5-year Superfund Program.

That proposal is way below the one that has come out of the Senate, of $7.5 billion, and of course, even further below the $10 billion proposal by the House.

Now, we are going into conference very shortly on Superfund, and the figure is not going to come down below the Senate level of $7.5 billion; that is a starting figure from this side. So we are going to have a serious problem.

Here we have a proposal that is going to come out substantially higher than the administration's recommendation, supported by generally dedicated revenues. There is a financing scheme in the works that takes care of it. And the budget appendix to the President's budget proposal states, and I quote here, "A revised request will be developed and submitted to the Congress once the program is reauthorized."

That is in the text, and I am anxious to know what this statement means in, let us say, the case of Superfund, if it is authorized at the higher level. What happens to the administration's stand in that case?

Secretary **Baker**. Do you mean how would the administration suggest that it be funded?

Is that the question?

Senator **Lautenberg**. Sure—or, would there be a serious consideration of this reauthorized program.

Secretary **Baker**. Well, I think as you indicated in your question, the President's position is clear that he supports reauthorization of Superfund, but he does not support it in excess of $5.3 billion, and he does not support it to the level that either the House or the Senate passed it.

During markup, it is my understanding that we supported a funding mechanism up to the $5.3 billion mark, but not beyond that.

Senator **Lautenberg**. So that this passage that I mentioned to you about the revised request really should be further amended to say only if the President agrees that it continues at the same level that he proposed in the first place?

Secretary **Baker**. Well, I think it is implied in there that that would be operative only in the event it became law, which would mean——

Senator **Lautenberg**. Well, what I am proposing to you is that this could become law, because we are at the conference level. If we come out with an agreement of something more than $7.5 billion, what then happens?

Secretary **Baker**. Well, then the bill would have to come down to the President to decide whether or not he——

Senator **Lautenberg**. Would he veto it?

Secretary **Baker**. Well, that is a decision that only he can make. I would not prejudge that.

Senator **Lautenberg**. Right, but based on your earlier comments that he is going to hold fast at $5.3 billion, and that——

Secretary **Baker**. No; that is not what I said, Senator. What I said was he is not going to be suggesting funding mechanisms for a program in excess of what he thinks is the appropriate amount to be reauthorized. I did not say he would veto it. He has not said whether he would or would not veto a reauthorization in excess of his level.

All I am saying is that he does not feel constrained to support a funding mechanism in excess of the $5.3 billion level. The minute he does that he is in effect saying fine, go ahead and reauthorize it at whatever figure you want.

Senator **Lautenberg**. Right. So the comment in the budget proposal notwithstanding, that does not suggest that a revised request will be developed once the program is reauthorized?

Secretary **Baker**. Should the program be reauthorized and become law, then there would be a revised request—that is what it means.

Senator **Lautenberg**. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Senator **Kasten** [presiding]. Thank you, Senator.

IMPACT OF OIL PRICE DECLINE ON ESTIMATES

Mr. Secretary, I am assuming that the economic projections that were developed in the underlying budget that you are testifying on today were developed over the fall and maybe the early winter, before we knew of the oil price decline that we are presently witnessing.

Could you tell us, No. 1, what the impact on gross national product and some of the other estimates, specifically the estimates for growth that are underlying in the budget, what is the impact of the oil price decline? Can we beat these estimates? I know some people have been criticizing us for being overly optimistic and rosy. It would seem to me that if these estimates were right before, they are going to be even more positive now, and that we would have a chance of beating the estimates. Therefore the deficit might be less than what we think it is.

Secretary **BAKER**. Senator Kasten, I think the primary effect would be to limit the number of challenges to the assumptions on the grounds that they are too rosy.

I think that one effect which we have seen from the oil price decline is that private economists are to some degree tending to revise their forecasts upward to meet the administration's forecast.

It is still our view that the 4-percent real growth figure is a reasonable figure—perhaps, all the more reasonable now, which is what you are suggesting. However, it is certainly too early to talk in terms of revising that estimate because we do not know where these prices are going to settle out, and we do not know how long they are going to stay there.

Senator **KASTEN**. I was just suggesting that if 4 percent was right in December, it is a whole lot more right now, and maybe 4.2, 4.3 would be something that we might sell.

I have one other question, and I am going to submit some questions for the record, because I know you have been here a long afternoon.

EFFECTIVE DATE OF TAX REFORM BILL

This question has to do with the effective date of the new tax law. A number of people are concerned about the provisions of the House-passed tax bill. One of the provisions which is, I think, most on the minds of small business people and the American taxpayer is the effective date, January 1, 1986.

A number of people are finding it impossible to make an intelligent tax decision in this kind of limbo they find themselves in.

Could you make some recommendations about what could be done to correct the House's action on this issue? Specifically, would you support legislation to clarify this dilemma for taxpayers that puts us on the record for an effective date on tax law might change, that the effective date would be January 1, 1987?

Secretary **BAKER**. Well, to enact broad-based legislation like that, Senator, could create as many problems as it solves, because it could require in effect a rush into certain preferences and deductions.

The question of the effective date of any new legislation is certainly a problem that we acknowledge and, I think, understand and appreciate. I think the best way to handle it is the way suggested by the resolution of the House of Representatives at the time the tax reform bill was passed. That resolution suggested that the chairman of the Ways and Means Committee, the ranking member thereof, the chairman of Senate Finance and the ranking member thereof, and the Secretary of the Treasury get together and, looking at each and every element of the package, agree on a joint statement that would remove the uncertainty.

Now, that was what we did in early 1985 with respect to the package that was then on the table, Treasury I, and we announced jointly that under no circumstances would this particular provision apply before such-and-such a date.

That is the best way to approach the problem, in my opinion, and we at Treasury are ready to do that.

Senator **Kasten**. I am not sure that the other people are as organized as you might be. But I appreciate your answer.

I just want to point out to you that there is an awful lot of concern, uncertainty, decisions being postponed, people in limbo. Whether or not the tax bill passes is one question, but this other question is compounding the problems, especially for a lot of small and medium-sized companies that do not have experts chasing the Senate Finance and House Ways and Means Committee, advising them day to day.

Mr. Secretary, I have a couple of other questions that I will submit for the record.

On behalf of the committee, I would like to thank you very much for your testimony here today.

The hearing is adjourned.

[Whereupon, at 3:50 p.m., the committee was adjourned.]

WRITTEN COMMITTEE QUESTIONS TO WITNESSES AND THE RESPONSES

WRITTEN QUESTION FROM SENATOR KASTEN

TAX EXEMPT STATUS

Question: Several weeks ago I wrote you about a revenue ruling request submitted to the Internal Revenue Service on behalf of a Wisconsin firm, the H.C. Prange Company.

Because of a filing oversight, the continued tax exempt status of an Industrial Development Revenue Bond is in question. Theirs is a simple, straightforward request, and should be answered quickly, one would think. However, inquiries my office has made to the IRS indicate that revenue rulings are no longer being made in this area, that it is unclear when the IRS will start making rulings in this area again, and that the delay is because of overall policy decisions which need to be made on the entire question of Industrial Development Bonds.

My question is twofold: when will the IRS begin making revenue rulings in this area again; and if there is going to be a significant delay, why can't an exception be made in the case of the H.C. Prange Company?

Answer: Under existing Treasury regulations, each principal user of a facility financed by an under $10 million exempt small issue IDB is required to file supplemental statements with the IRS listing certain capital expenditures incurred during the three-year period beginning on the date of issue. In addition, the issuer and the principal user of such a facility are required to file appropriate elections with the Internal Revenue Service.

Until recently, the IRS issued private rulings granting relief from the supplemental statements requirement, even if the statements were filed very late. However, the IRS has stopped issuing such rulings where the statements are more than two years late.

After considering the capital expenditure statements requirement, the Treasury Department has determined that the burden of the requirement on taxpayers outweighs its usefulness to the IRS. Consequently, the Treasury Department expects very shortly to issue regulations that retroactively delete the requirement to file such statements.

In addition, the Treasury Department expects very shortly to issue regulations eliminating the requirement to file an election with the Internal Revenue Service. Instead, issuers will be required to place a copy of the election with their other bond documents.

Once these regulations are issued, problems of the type faced by the H.C. Prange Company will be resolved.

WRITTEN QUESTIONS FROM SENATOR LAUTENBERG

On Tax Amnesty

QUESTION 1: The President is opposed to new taxes. But, a tax amnesty would get us revenues from old taxes. Is it safe to assume that the President would not oppose a tax amnesty on the grounds that it is a new tax? As between imposing new taxes, or offering amnesty to get in old taxes, which would be less objectionable to the President?

RESPONSE: The Treasury Department continues to study all issues raised by an amnesty, including anticipated revenue, and to monitor state results. The Treasury Department has long had reservations concerning the actual and perceived fairness of a Federal taxpayer amnesty program. This is in part a revenue consideration given the possibility that amnesty could have an adverse impact on taxpayer morale and thus voluntary compliance.

Irrespective of amnesty, tougher compliance measures should be adopted to improve enforcement of our tax laws. Additional revenue agents should be hired to ensure that taxes owed are paid. While the President has not ruled out an amnesty as a means of collecting unpaid taxes from past years, he will not support any new taxes.

The President has made clear his opposition to any tax increase, including any new taxes, for any purpose other than as a component of a fundamental tax reform bill that is revenue neutral in total. While the Federal budget deficit remains a problem, the Administration believes strongly that the deficit can and should be eliminated through substantial reductions in nonessential domestic spending, not by a tax increase in any form.

QUESTION 2: Since you expressed some concern that an amnesty might promote public disrespect for the law, and would be resented by those who pay their taxes:

Do you have any evidence that there has been a public revolt in those states that have had successful tax amnesty programs?

Are you saying that a family would prefer to tighten their belt -- by bearing cuts in government service or by paying new taxes -- rather than forgive someone tax penalties... someone who is willing to come forward and pay their tax plus interest?

Do you have evidence that the recent state programs were mismanaged?

RESPONSE: Taxpayer reactions to state amnesty programs have varied. Certainly, public opinion appears to have been most positive in those states in which amnesty and increased enforcement activities together were perceived as a success in raising revenue and improving future compliance. However, even in those states, concerns have been raised. For instance, the Illinois House of

Representatives has acknowledged that many honest taxpayers contacted their Representatives with fairness complaints following that State's amnesty. House Resolution No. 87, Eighty-Fourth General Assembly (March 13, 1985).

It appears that some states that offered amnesty achieved desirable reforms of their compliance laws at the same time. Nonetheless, serious questions remain as to whether this approach could be successfully applied at the Federal level.

OIL IMPORT FEE

QUESTION 1: OMB Director Miller, when he appeared before us, said he opposed an oil import tax. In fact, he said, if he had to raise taxes, he could find, and I quote, "better ways of doing it." Do you agree?

ANSWER: The Administration is opposed to all methods of raising taxes. We had indicated that an oil import fee might be considered in the context of obtaining a revenue-neutral tax reform bill, but in such context the revenues would merely be substituting for those from the income tax, and thus the imposition of an import fee could not be viewed as "raising taxes".

QUESTION 2: Please describe the impact of a fee on inflation, economic growth, and trade. Would it have a disproportionate impact on Northeastern states like New Jersey? By raising the cost of one of the essential inputs of our industrial, exporting firms, would a fee counter some of the positive effects on trade of the lower dollar? What would be the impact on oil consuming export firms if the U.S. imposed a fee and other nations, like Japan, did not? Would an oil import fee have the above-mentioned impacts, even if the revenue gain associated with the fee were offset by some unrelated tax expenditures in the context of a revenue-neutral tax reform measure?

ANSWER: An oil import fee would likely result in a modest short-term increase in the rate of inflation and a somewhat longer term reduction in real economic growth. The precise impact would depend in part upon the response to such fee by the Federal Reserve. If the money supply were increased to accommodate the fee, price increases would be higher, but the negative effect on real economic growth would be lower. The initial impact of an oil import fee on our balance of trade is likely to be favorable, as the level of oil imports decrease. However, because our manufacturers would face higher energy costs than foreign manufacturers, and because much of our exports go to oil exporting nations whose revenues would be reduced by the imposition of the fee, the ultimate effect may well be negative.

An oil import fee would clearly have a disproportionate impact on those regions that rely more heavily on fuel oil for heating or on residual oil for electrical generation and industrial use. This is particularly true for the Northeastern states. Although proponents of an oil import fee have sought to address this problem by exempting home heating oil and certain other products, it is likely that the regional impact would vary even with the proposed exemptions.

QUESTION 3: Assuming lower oil prices will boost economic growth, how much additional revenue will we take in, simply as a result of lower oil prices and the increased growth?

ANSWER: The impact of lower oil prices on federal receipts depends upon the relative magnitude of two offsetting factors, lower prices and higher growth. In general, federal revenues tend to increase with nominal, rather than real, gross national product (GNP). Because falling oil prices would likely result in a short term decrease in inflation, but a more persistent (and possibly greater) increase in real GNP, the net effect would be an increase in federal revenues (and a decrease in federal outlays).

On Cigarette Tax

Q. 1. I was pleased to see that the Administration is no longer opposing the continuation of the 16 cent level for the cigarette excise tax. I would like to know how you reached this decision.

A. 1. Under the Tax Equity and Fiscal Responsibility Act of 1982, the Congress temporarily doubled the excise tax on packages of cigarettes to 16 cents effective January 1, 1983, through September 30, 1985. Recent legislation extended the temporary increase through March 14, 1986. Because it seems certain that Congress will extend the tax once again and make it permanent, the Administration accepted the inevitable increase in the tax and included the increase in receipts in its FY1987 budget.

Q. 2. Can you estimate how much additional revenue we would get if we added another 8 cents to the tax, making it 24 cents, and how much we would get if we doubled it to 32 cents.

A. 2. Increasing the cigarette excise tax from 16 cents per pack to 24 cents and 32 cents per pack would raise approximately $1.7 billion and $3.3 billion per year, respectively.

Q. 3. Many health problems are considered smoking-related. Some analysts estimate the health costs of smoking to be anywhere from $8 to $27 billion a year. Some portion of that cost is borne by federal programs. I understand that the Administration is proposing user fees in some instances in which it believes that groups can be identified who benefit from particular services.

In this context, would you say that the cigarette levy is a tax, or is it more appropriate to call it a user fee?

A. 3. The levy on cigarettes is not a user fee, because payment of the levy does not depend upon an individual's use of a particular government service. User fees are amounts paid for a government service by those who receive direct benefits. The amount of user fee paid by an individual bears a direct relationship to the individual's use of a particular government service. In addition, a user fee excludes from the benefits of a particular government service those who do not wish to pay for it. For example, entrance fees to national parks are user fees, because they impose more of the costs of operation and maintenance of recreational areas on those who use them.

Q. 4. The Advisory Council on Social Security, which was head by Secretary Bowen a few years ago, called for earmarking a cigarette tax, or user fee, to offset smoking-related Medicare expenditures.

Is this proposal still under consideration by the Administration?

Would you be willing to reopen this issue?

A. 4. The Administration is not considering earmarking cigarette excise tax revenues for smoking-related medicare programs. Earmarking cigarette excise tax revenues would reduce budget flexibility and may misallocate funds. The appropriate amount of funds for smoking-related medicare programs may be more or less than the amount allocated to the trust fund. If sufficient revenues do not materialize, the programs will be underfunded. If revenues exceed expenditure commitments, then an incentive exists to finance additional programs rather than turn the funds over to the general fund. Moreover, earmarking funds for smoking-related medicare programs would enable these programs to have special treatment not afforded other programs that prevent or treat other equally serious diseases. Insuring a more efficient allocation of funds among health care programs would require that smoking-related programs be evaluated against other programs for the prevention and treatment of illness.

Q. 5. Can you supply for the record the latest estimates by the Department of Health and Human Services of the costs to federal health programs which can be attributed to cigarette smoking.?

A. 5. According to the Department of Health and Human Services, smoking-related diseases cost medicare and medicaid approximately $3.8 billion in 1980.

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1987

WEDNESDAY, FEBRUARY 19, 1986

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Armstrong, Kassebaum, Andrews, Grassley, Gorton, Chiles, Johnston, Sasser, Hart, Moynihan, and Lautenberg.

Staff present: Stephen Bell, staff director; and Charles Flickner, senior analyst for international security.

For the minority: Richard N. Brandon, staff director; and Douglas Olin, senior analyst for national security affairs and technology.

Chairman DOMENICI. The committee will come to order.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Mr. Secretary, we welcome you to your third year of testimony before the committee. We look forward to your customary thoughtful and candid testimony. Under Secretary Schneider and Administrator McPherson, we welcome you also. The three of you are becoming a most experienced team of witnesses. I imagine that that is giving ycu great stamina.

STATE'S GROWTH REQUEST HIGHEST

You have a tough job this year just justifying the budget request for international affairs. We all know now that the real growth in your request for security assistance and for the administration of foreign affairs of the State Department exceed those for other major programs including national defense. We also realize that most nondefense programs are being cut back. Others are limited in the budget request.

I read recently that the chairmen of several committees which have significant jurisdiction over your programs are predicting overall cuts from the administration's request of 30 to 50 percent. Frankly, I do not think that is going to happen, and I hope it does not.

The national defense and the international affairs functions are too important to absorb all of the reductions needed to meet the deficit of $144 billion next year.

Some soundings around the country would indicate that if anything is going to absorb the deficit requirements, it is defense. I assume the same people who are saying that would have added foreign affairs if they knew about it.

Well, obviously, it is not our purpose here today to propose to abolish our foreign affairs activities or the State Department or to terminate aid to Israel any more than we are going to give pink slips to the entire Marine Corps or privatize the Air Force. These are obviously major responsibilities, and we are concerned about them, and everyone on this Committee is.

FULL BUDGET REQUEST NOT POSSIBLE

Having stated my belief that your overall request will not be cut in a draconian manner, the 30 percent that some are talking about, let me hasten to add, Mr. Secretary, that your programs are unlikely to receive nearly as much in 1987 as they received this year. I regret to state that there are no exemptions in the Gramm-Rudman-Hollings discipline for international programs, and I am sure this committee will do its very best, but obviously, there should not be an exception.

I do not want to waste too much time discussing the overall amount requested for foreign aid, or for the State Department. We should focus on what we accomplish or fail to accomplish with the amount that is actually appropriated.

Mr. Secretary, I am sure that you had an opportunity to review an article by Ambassador Kirkpatrick in Monday's Washington Post. If there is no objection, I would like to have the article printed in an appropriate place in the record.

[The article referred to follows:]

[From the Washington Post, Feb. 17, 1986]

A BIG BILLION

(By Jeane Kirkpatrick)

Why, in this year of zillion-dollar debt, big deficits, deep domestic spending cuts and Gramm-Rudman, has the Department of State proposed to increase foreign assistance by a billion dollars? Secretary of State George Shultz tells us there is no problem, that his budget request is "fully consistent with the targets on the deficit set out by Gramm-Rudman," but it is hard to follow his logic. And it is even harder to understand some of State's specific aid requests.

Why, for example, does the State Department want to give nearly three times as much assistance to sub-Saharan Africa (not counting humanitarian food assistance) as to South America? ($931 million to $364 million.) Why does the State Department propose to give 25 million American dollars to help Marxist Mozambique, whose government is wholly surrounded by Soviet bloc troops, in the same year it seeks aid for anticommunist insurgents all over the world?

Why is $25 million proposed for Zimbabwe—one-party state that represses its opposition, arrests and tortures its opponents and consistently opposes U.S. foreign policy—in the same year State proposes nothing for the reliably pro-Western Ivory Coast?

And, looking at two island countries on Africa's East Coast, why is more than $2 million proposed for the Seychelles, which provides basing rights and other services to the Soviet Union, while less than half that amount is proposed for the truly neutral, independent Comoros?

Why does the State Department seek $18 million for Ghana's government, which has supported Soviet policies in Africa and elsewhere and has welcomed several thousand Soviet bloc troops, but less than one-third that amount for neighboring Togo, which shows good will to the West and courage in the face of Qaddafi's threats?

Doubtless, there are reasonable answers to these questions, and State Department representatives will have an opportunity to provide them as they explain their priorities to Congress. It promises, however, to be quite a struggle.

Foreign aid is one of the least loved, most vulnerable expenditures of any U.S. administration. Public-opinion polls regularly register popular hostility toward high levels of foreign assistance. Candidates for office regularly promise to cut foreign aid budgets. But the amount of public money requested, appropriated and spent on foreign aid—multilateral and bilateral—continues to climb.

A revolt appears to be in the offing. Senate Foreign Relations Chairman Richard Lugar warned Shultz that in making this year's request for increased assistance he was "courting catastrophe." The Democrats have reacted most strongly. "If we can't continue to pay our own bills, we can't afford foreign aid," House Appropriations subcommittee Chairman David Obey (D-Wis.) announced, adding that he was preparing a 50-percent cut in the State Department request. House Foreign Affairs Chairman Dante Fascell (D-Fla.) predicted that 15 to 30 percent would be shaved off the agency's request.

Would it matter anyway? The answer depends less on the amount cut than on *what* is cut.

Obviously, foreign assistance is one of the instruments of foreign policy that can be used along with diplomacy, information and military strength to accomplish our national purposes and protect our national interests. One of our national purposes is, and always has been, to help people in dire need—such as victims of famine in the Sahel. No one, however, suggests that this is the principal justification for our huge annual foreign assistance budgets.

Usually, U.S. foreign assistance is justified by sweeping assertions that it will "enhance regional stability" or help others "strengthen their economies." Occasionally, it is suggested that foreign assistance gives us "leverage" (though examples are rarely provided to support the assertion), or that it prevents a country from becoming "wholly dependent" on the Soviet Union—which, in fact, rarely provides economic assistance to any country except its client states that are already wholly dependent.

Today, complaints about the level of U.S. foreign assistance are countered with vague references to the lion's share consumed by Israel and Egypt. That, in turn, is justified as "advancing the peace process," to which, presumably, the roughly $90 million proposed for Jordan is also expected to contribute. The fact that the "peace process" has been stalled for years has had no perceptible effect on assumptions about these huge aid programs.

Sometimes, as in the Dominican Republic, El Salvador, Costa Rica, Honduras, Guatemala, Peru, Bolivia and Sri Lanka, foreign assistance is justified as part of a broad effort to help build democracy and also contribute to U.S. security. In fact, I believe it does both in the above cases. Some foreign assistance programs clearly do serve both our ideals and our national interests.

But too many U.S. aid programs have come to be viewed as "entitlements." Too many have become disconnected from realistic or hard-headed calculations of American interest or democratic institution building.

One hopes that in examining this year's foreign aid budget, Congress makes discriminating judgments and does not succumb to the temptation of across-the-board cuts.

SPENDING AND OBJECTIVES NOT IN SINK

Chairman DOMENICI. She expressed better than I can my reluctant conclusion that some of our international spending does not accomplish important international objectives. I am not suggesting here that that is all your fault. I think if it is true, that we certainly share in that. We do not seem able, both the Congress and the Executive, to effectively support one of the major accomplishments of recent years, the emergence of democracy in almost every nation in the Western Hemisphere, and I hope you will address that today.

The fact that budget requests for fiscal 1987 include large increases for the Western Hemisphere does not alleviate my concern. Before Gramm-Rudman-Hollings, we were able to direct part of a growing worldwide foreign aid to the Caribbean and Central American areas. There was no need to seriously reexamine our inherited priorities in other areas. There was plenty of aid to go around.

In fiscal 1986 and the coming budget, this abundance no longer exists. You are well aware of the onerous job that occurred in assuming the 4.6 percent cuts, the automatic first round in Gramm-Rudman on March 1, 1986.

You have made some difficult decisions in December when Congress cut the fiscal year 1986 request by about $1 billion, preceding the automatic cuts. Because of Congress' earmarks of minimum amounts to certain countries, earmarks that were not strongly contested by the administration, reductions for countries involved in the Middle East peace process, Israel and Egypt were limited to the 4.3 percent mandated by Gramm-Rudman-Hollings. Requests for other countries including those in Central America that are undergoing difficult transitions were cut approximately 20 percent, and a few were cut 50 percent. This does not seem to me to make the greatest sense.

SOME PROGRAMS SEEM ENTITLEMENTS

As Ambassador Kirkpatrick points out, the fact that the Middle East peace process has been stalled for years has had no perceptible effect on assumptions about huge programs. They have almost become an entitlement.

Let me continue to quote.

> Sometimes, as in the Dominican Republic and El Salvador, Costa Rica, Honduras, Guatemala, Peru, foreign assistance helps build democracy and also contributes to U.S. security. It serves both our ideals and our interests. Too many U.S. aid programs have come to be viewed as entitlements. Too many have become disconnected from realistic calculations of our interests or of democratic institution-building.

Tomorrow, as I understand it, Mr. Secretary, our President travels to the tiny island nation of Grenada to participate in a national festival of liberation. Most of us are proud of what was accomplished there, but the task is proving to be far less simple elsewhere in the region.

Over the past 5 years, the President and Congress have undertaken to support the people of the Caribbean and Central America in their struggle for opportunity and freedom. The United States has a vital national interest there and in South America, where violence, poverty, enormous debt, decline in middle-class standards of living threaten stability; almost everywhere, Cuba and the Soviet Union take advantage of these problems.

If we in Washington continue to do business in the future—and I use "we"—as we have in the past, there will be no possibility of our taking advantage of the one-time opportunity for our generation to support transitions to democracy and opportunity in Latin America and some other parts of the world.

If more than two-thirds of the shrinking foreign assistance budget continues to go to those nations which seem to have an entitlement and to base-access countries, there will not be much less for the rest of the world. Freedom and stability in Latin America soon may be as distant as peace in the Middle East. I do not think we can let that happen. I have had the privilege of learning a bit about that, and perhaps that is why I am concerned.

I yield to the distinguished Senator from Florida.

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Thank you, Mr. Chairman.

Mr. Secretary, we welcome you to the committee.

NO COHERENT INTERNATIONAL ECONOMIC POLICY

As I have expressed to you in the past, I fear that the administration does not have a coherent international economic policy. The past years have demonstrated continued passivity and inaction on the growing trade imbalance. And no solutions have been offered to address the continuing international debt crisis. No comprehensive framework has been developed to effectively utilize the ever growing billions you are requesting for foreign aid.

The 1987 request for international affairs reflects extraordinary growth. Since 1980, outlays for foreign aid have been one of our fastest growing areas of the Federal budget, a 113 percent increase overall. This year again, an additional $1.3 billion increase is requested.

I am not opposed to foreign aid per se. The Marshall plan, one of our most massive foreign assistance programs in history, stands out as one of this nation's finest accomplishments. The Marshall plan, however, was focused. It had a realistic quota. It had realistic goals, and it was well managed and funded at appropriate levels. It was a solution to a problem, and it was a plan of action, not an excuse for inaction.

Foreign aid should be able to help Third World nations try to develop economic and trade policies which work to the benefit of both nations. Certainly, tradeoffs need to be made here as well.

Administrative policies to spur development in the Third World through opening U.S. markets were wonderful for the economies of Southeast Asia, but they were devastating for the U.S. textile industry. Last year, the President vetoed the textile bill. I happened to agree with that veto. That kind of protectionist measure could do more harm than good. But what is being done to redress the development policies that helped create a boom for Thailand, Indonesia, and Korea left nothing for our textile workers?

Last year, Congress cut over $1 billion from the President's foreign aid request. I happen to think that that was more than just an arbitrary reduction designed to reduce the deficit. It was an acknowledgement that tradeoffs need to be made and that programs need to be tightened up.

The annual $5 billion Economic Assistance and Humanitarian Assistance Program has $8.8 billion in undisbursed moneys backing up in the funding pipeline. We certainly need to focus on that. An $11 billion military aid program, growing at over 15 percent a year, with almost $8 billion in prior year funds backlogged and unspent, should be able to absorb some new requirements without an increase in the funding.

Until our foreign aid programs can be justified within a comprehensive policy framework and measured in terms of success, large increases in our present budget situation cannot be justified. While we are cutting back on all sorts of Government funding, it is doubly hard to support increases in these particular programs.

NO COHERENT TRADE POLICY

At the same time, this administration does not have a coherent trade policy. The administration has followed macro policies that have severely damaged our trading industries and then refused to deal with the consequences of that policy. Last year, the International Trade Commission voted unanimously to extend relief to the shoe industry, but the administration refused to enforce that ruling. Is it any wonder that protectionist pressure grows when the administration refuses to enforce the existing trade laws?

Only because of congressional pressure has the administration occasionally dropped its passive trade policy. And because the administration lacks the comprehensive approach to trade, it finds itself dealing with our problems on a piecemeal basis. What we have learned in Congress in the last several years is that it is not enough to authorize the President to act. What I suspect you will see from this Congress will be comprehensive, nonprotectionist trade laws that will compel the President to act.

Chairman DOMENICI. Thank you very much, Senator Chiles.

Mr. Secretary and those who are with you, we now welcome your testimony. We have your prepared remarks. We will make them a part of the record, but you may handle it as you see fit. You can deliver it in its entirety, or you may summarize it.

STATEMENT OF HON. GEORGE P. SHULTZ, SECRETARY OF STATE, ACCOMPANIED BY RONALD I. SPIERS, UNDER SECRETARY FOR MANAGEMENT; WILLIAM SCHNEIDER, JR., UNDER SECRETARY FOR SECURITY ASSISTANCE, AND PETER McPHERSON, ADMINISTRATOR, U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

Secretary SHULTZ. Thank you, Mr. Chairman.

If I may, I would like to take advantage of your invitation to put the long testimony in the record,[1] and I have a briefer version here that I would like to read in a moment.

Chairman DOMENICI. Please proceed.

Secretary SHULTZ. I would like to make a couple of comments on the introductory remarks by you and Senator Chiles.

First of all, it seemed to me to a certain extent in your comments, you expressed the dilemma that we face because when you talked about money, you said we should have less, and when you talked about policy, you said we should have more. That is the dilemma. And it takes money often to be able to express our interests around the world.

I do not think I owe any apologies for the level of this budget, unless it is an apology following your policy remarks, that we have not done enough. But in my testimony, I hope to be able to show why we need the budget that we have proposed.

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[1] See p. 439.

STATE BUDGET IN LINE WITH GRAMM-RUDMAN

With respect to the Gramm-Rudman-Hollings bill that you referred to, I should point out that what is proposed by the President is completely within the concept of that bill. So if you just adopt the President's budget, you will be within the concept of that bill, and it includes everything that we have proposed here.

Chairman DOMENICI. Mr. Secretary, let me just say that you might interpret my remarks that way. What I said was that this year we are going to have less than you requested, and if we continue with the current method of allocating the smaller amount, we are not going to be able to take care of some of the areas that may turn out to be more important than areas we are taking care of through earmarks. That is not my ultimate decision, but that is my current observation. That is what I was trying to express.

Secretary SHULTZ. Thank you.

ADMINISTRATION HAS TRADE POLICY

As far as the lack of a policy is concerned, I do not agree. I think we do have a policy. You do not agree with it, but it is a policy nevertheless, to try to work for open markets around the world, including here.

Protection is a policy. We tried it in the 1930's, and it was a catastrophe. We have to remember that. And that does not mean that we should do nothing about many of the problems around the world and seek to open markets, but it does mean that we have to hold onto the fundamental principles of policy here. And the administration does have one—and I recognize that you may not agree with it, but nevertheless it is a policy.

It is part of what has produced almost 10 million new jobs since mid-1982.

Senator CHILES. It is part of what has moved our manufacturing base overseas.

Secretary SHULTZ. There are certainly problems in our economy, but we have a very strong growth in employment, we have a reduction in inflation in the last 5 years—it is about one-third what it was. That is attributable in part to the fact that our economy is subjected to international competition.

I used to be involved in the automobile industry, so I know a little bit about it, and does anybody here think that the current, I think quite good, small and high-quality automobiles being churned out of U.S. production lines would be like they are if they did not have international competition to look at?

So it is not something to throw away. It is good for us, and it is a policy.

The debt problem is a big problem. There is a strategy. There is a program for dealing with it, but it is not easy. It is a problem that we inherited, and we are struggling with it. But it has not gone unattended.

So I just want to say that I listened carefully; I understand the validity of your comments, but at the same time, I think there are arguments that can be made on the other side, and I will proceed to do it, I hope, in my prepared testimony.

I welcome this opportunity to speak in support of the President's fiscal year 1987 budget request for the International Affairs Function, budget function 150.

MUST GET OUR ECONOMIC HOUSE IN ORDER

Our request comes before this committee at a time of great debate over how to reduce our Federal budget deficit. As a former budget director, I know from experience that there are no easy choices, and I am determined to have the Department of State do its fair share in getting the Federal budget under control.

In fact, the greatest single contribution the United States can make to the well-being of the developing world is to get our own economic house in order, which is mainly a problem of our fiscal deficit.

As recent history demonstrates, strong U.S. growth and lower U.S. interest rates are crucial to the rest of the world and to the developing countries in particular. Greater fiscal discipline in the United States will help the U.S. economy stay on a moderate, noninflationary growth path projected by the Council of Economic Advisers. This will be of double benefit to the developing countries. We will be a good market for their exports, and lower interest rates will relieve some of their daunting burden of debt.

Together, a 4-percent growth in the United States and another drop in the U.S. interest rates should improve their external position by approximately $10.4 billion in 1986 alone.

CIRCUMSTANCES DRIVE BUDGET REQUEST

One of my responsibilities as Secretary of State is to present to you the essential costs of conducting a successful foreign policy. These costs cannot be wished away. They are required if we are to safeguard our national security and international interests. We recognize that we have a burden of proof to meet in requesting more funds. I can assure you that in preparing this budget, every attempt was made to economize.

The increases over fiscal 1986 levels contained in our fiscal 1987 request come mainly in improving protection of our diplomatic personnel and facilities abroad. And I might say we just had another incident yesterday in which a car bomb exploded in front of our Embassy in Lisbon. Nobody was hurt, probably in part because of some of the protective measures we have taken.

Were it not for the need to provide greater security for them, our current request for Function 150 would be lower than the amount originally requested for fiscal 1986. In fact, our request is $3.9 billion less than the amounts actually appropriated by the Congress for the International Affairs Function in fiscal 1985.

Our security assistance request, which seems higher when compared to the post-Gramm-Rudman-Hollings levels of fiscal 1986, is essentially the same as we requested in fiscal 1986. We are not seeking large increases in security assistance; rather, we are continuing to seek a level of resources adequate to meet our commitments and safeguard our interests.

As the President has observed, national security has to be our Government's highest priority. The resources we are requesting have been accommodated within the fiscal 1987 budget, and the deficit target contained in the Gramm-Rudman-Hollings legislation.

The fiscal 1987 budget request for the International Affairs Function totals $22.6 billion: $2.1 billion above the fiscal 1986 post-sequestration levels; $1.4 billion above the amounts appropriated by the Congress for fiscal 1986, but $200 million below the amounts originally requested by the President for fiscal 1986.

Let me first speak to two major areas of increase over the postsequestration levels.

The largest increase—$1.5 billion for the State Department's operating budget—reflects the administration's proposals to protect our people and diplomatic posts overseas from international terrorism. We in the State Department and our colleagues from other agencies serving abroad are on the front line. The courage and patriotism of our people and their families in facing the dangers of terrorism are inspiring. We must ensure their safety.

The Congress urged us strongly to develop a comprehensive program. We have done so and we are now presenting it to you.

DON'T SUCCUMB TO FALSE ECONOMIZING

The second major area of increase is to restore security assistance levels necessary to meet our international commitments and to pursue our priority foreign policy objectives. Helping our friends defend themselves is our first line of defense. We must not succumb to false economizing—leaving ourselves and our friends more vulnerable in areas vital to international security.

Let me address the major budget components and the objectives they serve. Our development and security assistance request for $16.2 billion serves four main foreign policy objectives: supporting the Middle East peace process; strengthening our alliances and cooperative defense relationships; promoting regional stability in Central America and the Caribbean, and supporting economic reforms and democratic forces throughout the world. These objectives are interrelated—and crucial.

Nearly 34 percent of these resources go to Israel and Egypt in support of our search for peace in the Middle East. I might say that those are largely earmarked funds by the Congress.

Assistance to the base rights countries of Spain, Portugal, Greece, Turkey, and the Philippines and to military access and front-line states such as Kenya, Oman, Morocco, Korea, Pakistan, and Thailand represent another 26 percent.

Our efforts to promote regional stability in Central America and the Caribbean take another 11 percent. There are other countries of importance to us which share our democratic values, such as India and Colombia; or where new democracies have emerged, such as Bolivia and Uruguay; or where fundamental economic reforms are taking place such as Ecuador and Senegal; or that are simply strategically important to us, like the island states of the South Pacific. When these countries prosper and remain free, they demonstrate to the world that the benefits of open societies and open economies transcend geographic size and cultural diversity.

All other country programs account for only 3 percent of the total foreign aid request. Some are poverty-stricken African states to which we are directing our humanitarian and technical assistance programs. Others, like Mozambique, are moving from the Soviet bloc toward genuine nonalignment. Still others, such as Burma and Peru, are active partners with us in the war against international narcotics trafficking.

Finally, some 9 percent of our assistance goes to AID noncountry programs and a number of generously beneficial efforts including the Peace Corps, refugee assistance and narcotics control efforts.

Let me now do a brief tour of the world to discuss the specific policy objectives I outlined earlier.

THE MIDDLE EAST

Peaceful solutions in the Middle East will become possible when we and our friends make it clear that radical solutions get nowhere. Our commitment to Israel and her security is rock solid, and our levels of assistance must reflect that commitment.

At the same time, we must continue to provide significant support to Egypt—when we speak of the peace process, we have to remind ourselves that the peace treaty with Egypt is the fundamental building block of it, and we need to keep it there and keep it in place—Egypt, which had the courage to break ranks with the rejectionists and make peace with Israel. A sound Egyptian-Israeli relationship remains the cornerstone of our broader peace efforts and our regional security policy.

We must also help our moderate friends in the Arab world defend themselves against the genuine security threats they face.

ISRAEL'S ECONOMIC REFORMS

Last year, we sought and the Congress appropriated $1.5 billion in supplemental assistance to support Israel's economic reform program. Buttressed by this assistance, Israel has made significant progress in stabilizing its economy since last summer.

The combined impact of new fiscal and monetary policies on inflation has been dramatic. The monthly rate of inflation declined from 27.5 percent in July to 1.3 percent in December.

Meanwhile, the positive trend in the balance of payments, which began in late 1983, has continued. Israel ran a substantial civilian current account surplus in 1985 due to continued improvement in its balance of trade and substantial increase in transfers from abroad. This improvement resulted in more than a billion-dollar increase in official reserves, from the midyear low point to about $3.2 billion at year's end.

Israel's foreign debt stabilized, and its maturity structure improved, as short-term debt was repaid during 1985. U.S. economic support funds and disbursements from our fiscal 1985 supplemental appropriation for Israel made an important contribution.

The remainder of our supplemental, which was a one-time emergency assistance measure, will be disbursed in fiscal 1986 in support of further Israeli reform efforts.

Notwithstanding the considerable progress made so far, Israel's stabilization program remains fragile. The major problem continues to be excessive government spending. The new Israeli budget moves in the right direction, but additional reductions in government spending are necessary. Recent wage increases are also cause for concern. Future wage increases need to be linked to increases in labor productivity. Over the longer term, the government of Israel would do well to consider reforms in a number of other areas. These include delinking financial assets from domestic price indices, labor market reform, and changes in investment and tax policies. I might say the outstanding work of the Operation Independence group under the leadership of Max Fisher has, I think, a great potential for future development in Israel, and this is a private effort.

EGYPTIAN ECONOMIC PROGRAM

Last year, at the administration's request, Congress also appropriated $500 million in supplemental assistance for Egypt. These funds, along with our regular assistance program, were in support of economic reform. In 1985, the Egyptian Government drew up a major reform program. It raised prices for agricultural commodities, for example, and for a wide range of sensitive consumer items. It also raised electricity rates by more than a third and gasoline prices by 25 percent. These incremental actions, however, still fall far short of the comprehensive effort needed for long-term economic viability.

During 1986, we will time our disbursement of the remaining $150 million of the supplemental to support further reform measures. Priority areas include reducing the balance of payments and budget deficits, improving the system of debt management, and expanding the role of the private sector. Rapid progress in these areas is all the more urgent now, given the damaging impact on the Egyptian economy of the precipitous drop in oil prices.

ENHANCING DEFENSE AND SECURITY RELATIONSHIPS

Around the world, America's alliances and security relationships are sound. Alliances among free nations will always see expressions of differing perspectives. But on the fundamental issues of our mutual security, the Atlantic alliance remains solid.

On the other side of the globe, we continue to regard the United States-Japanese Mutual Security Treaty as the pillar of Asian peace and stability. Japan has become our largest market after Canada, and both sides are working toward resolving our trade differences.

We are also working with the Republic of Korea, whose security has never been more important to us, on trade issues and mutual security and resolving market access problems in our expanding two-way trade. While we have some serious problems with New Zealand, Australia remains a valued ally.

Our aid programs concentrate on the region's more threatened or vulnerable nations: the Philippines, the Republic of Korea, and Thailand.

Ambassador Philip Habib is currently in the Philippines assessing the situation there for the President, and we expect his report to influence the course of our efforts to assist the Philippines through this prolonged crisis.

In the meantime, we are taking care to ensure that our aid contributes to the structural reforms needed to put its economy back on the path of growth.

Our military assistance to the Philippines remains our best and most useful tool to help promote the reform and development of a professional military. Whatever the near-term problems of the Philippines, there is no doubt that the presence of a strong, democratically oriented military is in our best interests.

It is also time to fund military assistance at a level necessary for the armed forces of the Philippines to fight the insurgency successfully.

In South Asia, the Soviet aggression in Afghanistan has continued for more than 6 years. Pakistan's staunch opposition to Soviet aggression and its generosity to more than 2 million Afghan refugees impose an enormous financial burden on Pakistan, which the United States has tried to alleviate through our current 6-year economic, 5-year military program of assistance. This program enters its final year in fiscal 1987. We must maintain that support, out of loyalty to a staunch ally that faces a direct Soviet threat, and to maintain the pressure on the Soviets to move toward a negotiated settlement in Afghanistan.

CENTRAL AMERICA AND THE CARIBBEAN

Events in Central America and the Caribbean over the past year have confirmed the important link that exists between foreign assistance and U.S. national interests. Our continuing policy of support to prodemocratic forces is enabling democracy to take root and to become self-sustaining.

Guatemala is the latest Central American country to have abandoned military rule for elected civilian government. Elected civilian leaders have replaced authoritarian regimes in El Salvador and Honduras.

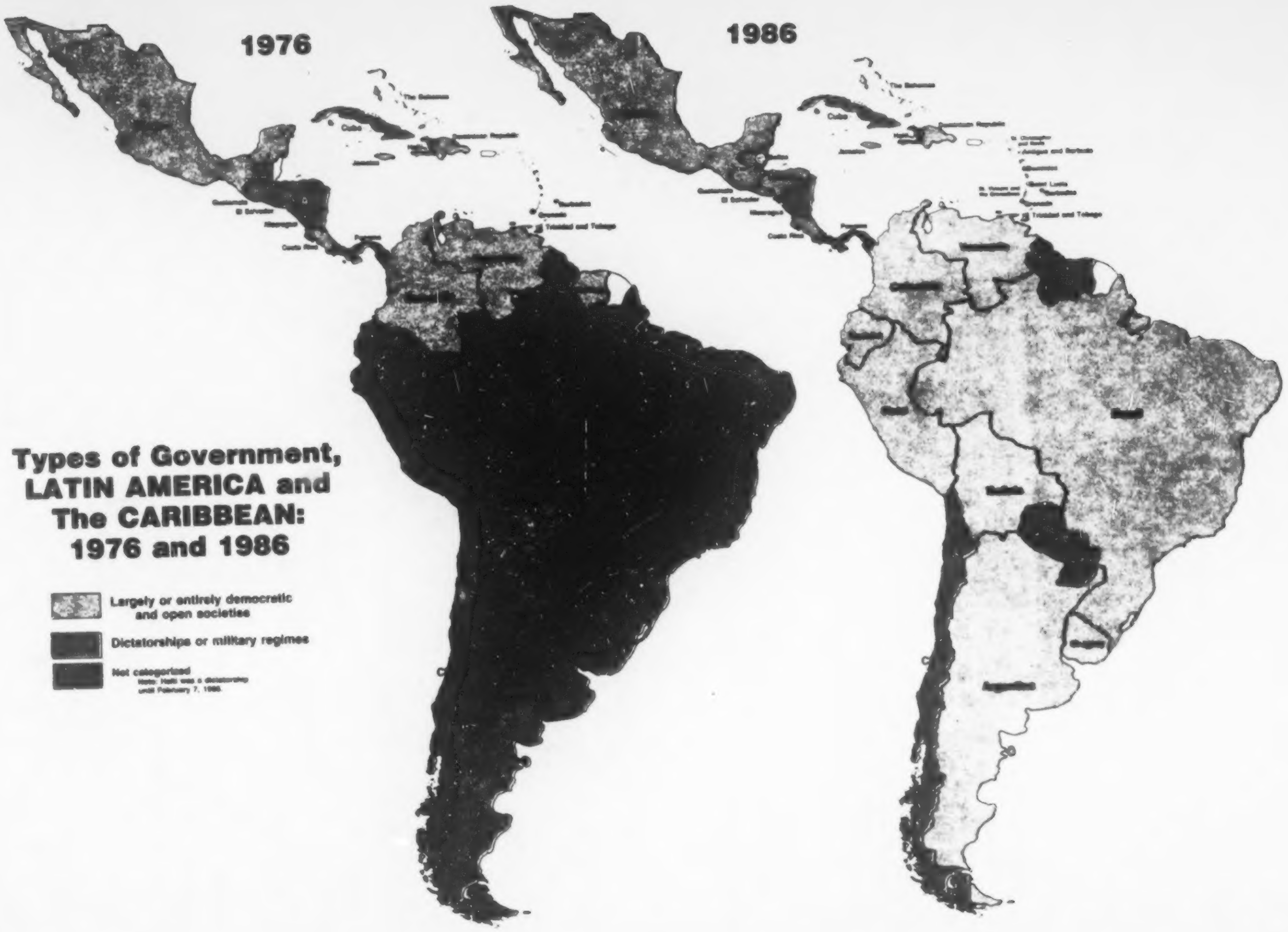
I might just say there were some maps passed around, a rather dramatic picture. I think you have them there, and they are just showing you the difference between now and 10 years ago. It is a dramatic picture and one that is very much in our interest, and it is quite obvious to see where the difficult points are.

GREATEST DANGER FROM NICARAGUA

The most immediate danger to democracy in Central America, of course, is the assault on it from Communist Nicaragua, aided by Cuba and the Soviet Union. Democratic El Salvador is an outstanding example of a country that has managed to withstand a Communist insurgency, and we have been privileged to play a part by our encouragement and help.

So our policy—if we keep at it—is working. And we must support—not abandon—the democratic resistance within Nicaragua, which we support for both moral and strategic reasons. We will be discussing with the Congress what this moral and strategic imperative requires.

The past few years have also confirmed the connection between freedom and economic progress. The world economy is still troubled, but nations everywhere are rediscovering the basic truth that



Types of Government, LATIN AMERICA and The CARIBBEAN: 1976 and 1986

1976
1986
The Bahamas
Cuba
Jamaica
Dominican Republic
Guatemala
El Salvador
Nicaragua
Costa Rica
Panama
Barbados
Grenada
Trinidad and Tobago
Antigua and Barbuda
St. Lucia
Largely or entirely democratic and open societies
Dictatorships or military regimes
Not categorized
Note: Haiti was a dictatorship until February 7, 1986.

the source of economic growth is individual creativity, not the state. The same laws of economics apply to developed and developing countries alike, and those that apply its truths are reaping the rewards.

THE AFRICAN CONTINENT

In Africa, young and fragile governments are struggling with the most profound economic crisis in the continent's modern history. Our adversaries have shown themselves willing to take advantage of the continent's plight, exploiting political-military conditions in such disparate areas as southern Africa, Chad, and the Horn. It is in our own interest to help Africa realize its potential: to fuel economic growth; to monitor and thwart the actions of Libya, the Soviets and their surrogates, and to encourage adherence to improving standards of human rights.

For the long term, we must encourage Africans themselves to promote the policies that lead to agricultural productivity, economic growth, and stability. There is cause for hope. Some African countries are starting to reject the statist economic policies which proved so disastrous, misallocating scarce resources and discouraging the productive private sectors of the economy.

SOUTHERN AFRICA

Turning from purely economic to more general concerns, no region of Africa is the cause of more debate and concern, both in the United States and abroad, than southern Africa.

We are committed to playing a positive role as the region grapples with the twin challenges of continuing regional strife and bringing the abhorrent system of apartheid to an end.

DEVELOPING COUNTRIES

The multilateral development banks play an important and complementary role in many countries important to the United States. As developing countries seek to move from crisis management and austerity to a renewal of sustained economic growth, they will be competing for a finite supply of investment capital from the international financial community. These resources will flow where they are welcome—when conditions are hospitable.

A true partnership based on mutuality of interest will have to be forged between the developing countries and the holders of development capital—the industrial countries, international lending institutions, and the commercial banks.

Restrictive trade practices have only compounded the problems of many heavily indebted developing countries. All too typically, heavy foreign borrowing has supported fiscal deficits and overvalued exchange rates, putting a great burden on export competitiveness. Import barriers have been erected to protect favored domestic industries from foreign competition. These barriers have severely hampered the growth of trade among developing nations.

The developing countries and the industrialized world have one thing in common: all of our peoples are winners if we have a stronger and fairer world trading system. We hope the developing countries will work with us on a new trade round to overcome the narrow interests that threaten our common progress.

TERRORISTS DRIVE UP BUDGET

I would like to conclude by elaborating on my earlier comment about the requested increase in our operating budget.

Over the past few years, the world's attention has been riveted to terrorist dramas unfolding around the globe. I have spoken frequently on this subject. Civilized nations and civilized peoples have been inadequately prepared for it. That can and must change.

We must do everything we can to thwart those who seek to advance their ends through terror and to ensure the safety of our citizens abroad. Even in this period of budgetary stringency, this task must be a priority.

We have designed a program which in our view is prudent and efficient in its commitment of resources, yet responsive to the inescapable necessity we now face.

With this goal in mind, and knowing of the great concern in the Congress, I formed the Advisory Panel on Overseas Security chaired by Admiral Inman. The panel exhaustively researched all aspects of our security and counter-terrorism programs. Its recommendations have vision. Equally important, they are practical. They are recommendations which, with your support, we can act on.

And I might say, as we have had hearings before various committees, I believe including this one, at times of terrorist crisis when our embassies are under attack, I have been told by member after member that we must spend whatever is necessary to provide adequate protection, and that we should design a program that of course watches the penny, but nevertheless does not compromise security. So we have done it.

We are requesting $4.4 billion spread over 5 years. Of this total, $2.7 billion is for construction, and the balance is for operating expenses, including security officers, residential security improvements, and more secure communications equipment.

In fiscal 1986, the administration is requesting $237 million for salaries and expenses, and $455 million for construction. In fiscal 1987, the request is $304 million for salaries and expenses, and $1.1 billion for construction.

The administration's proposed program will not solve all of our security problems, but we can minimize them. Our proposal is a comprehensive and long overdue security program which addresses our most basic security concerns.

In summary, Mr. Chairman, the world remains a turbulent and sometimes dangerous place, but as we look ahead, we draw strength from our ideals, from our friends, and from the young democratic nations who have joined our ranks and now look to us for support.

America remains a beacon to the freedom-loving peoples of the world. Powerful trends are the side of freedom. That is one of the lessons of 1985.

Another major lesson of the recent past is that realism, strength, and staying power are crucial prerequisites to meeting these international challenges. History will not do our work for us. We have to be worthy of our opportunities.

The noble tradition of bipartisanship, which brought us so many dividends in the post-war years, does not ask any of us to abandon our principles. But it does require all of us to recognize how much harder it is to meet foreign challenges if we are not united at home.

In recent years, we have seen signs of a rebirth of the post-war national consensus—based on a realistic understanding of the world as it is, and of the need to negotiate differences where possible.

The President has asked me to reiterate his commitment to work in a bipartisan spirit with all members of the Congress on behalf of the peace, freedom, and security of this country.

Thank you.

Chairman DOMENICI. Thank you very much, Mr. Secretary.

[Secretary Shultz's prepared statement follows:]

PREPARED STATEMENT OF HON. GEORGE P. SHULTZ, SECRETARY OF STATE

Mr. Chairman and Members of this Committee:

I welcome the opportunity to speak in support of the President's Fiscal Year 1987 budget request for the International Affairs Function -- budget function 150. Our request comes before this Committee at a time of great debate over how to reduce our federal budget deficit. As a former budget director, I know from experience that there are no easy choices. And I am determined to have the Department of State do its fair share in getting the federal budget under control. In fact, the greatest single contribution the United States can make to the economic well-being of the developing world is to get our own economic house in order.

As recent history demonstrates, strong U.S. growth and lower U.S. interest rates are crucial to the rest of the world, and to the developing countries in particular. For example, a fall of 2 percent in U.S. real GNP in 1982 resulted in a 13 percent decline in U.S. imports from developing countries, while 7 percent U.S. growth in 1984 was associated with an 18 percent rise in U.S. imports from the developing world. U.S. interest rates are translated directly into interest payments required from indebted nations. In 1983, the U.S. prime rate fell from 15 to 11 percent.

That year, interest payments fell by almost $9.5 billion, while the debt outstanding from developing countries actually increased. Greater fiscal discipline in the United States will help the U.S. economy stay on the moderate, non-inflationary growth path projected by the Council of Economic Advisers. This will be a double benefit to the developing countries: We will be a good market for their exports, and lower interest rates will relieve some of their daunting burden of debt. Together, a 4 percent growth in the U.S. and another drop in United States interest rates should improve their external position by approximately $10.4 billion in 1986 alone.

One of my responsibilities as Secretary of State is to present to you the essential costs of conducting a successful foreign policy. These costs cannot be wished away. They are required, if we are to safeguard our national security and international interests. We recognize we have a burden of proof to meet in requesting more funds. I can assure you that in preparing this budget, every attempt was made to economize.

The increases over FY 1986 levels contained in our FY 1987 request come mainly in improving protection of our diplomatic personnel and facilities abroad. Were it not for the need to provide greater security for them, our current request for Function 150 would be lower than the amount originally requested for FY 1986.

In fact, our request is $3.9 billion less than the amounts actually appropriated by the Congress for the International Affairs Function in FY 1985.

Our security assistance request, which seems higher when compared to the post-Gramm-Rudman-Hollings levels of FY 1986, is essentially the same as we requested in FY 86. We are not seeking large increases in security assistance; rather, we are continuing to seek a level of resources adequate to meet our commitments and safeguard our interests. As the President has observed, national security has to be our government's highest priority. The resources we are requesting have been accommodated within the FY 87 budget and the $144 billion deficit target contained in the Gramm-Rudman-Hollings legislation.

Mr. Chairman, the support that Congress has provided in the past has been invaluable in strengthening America's position in the world. As I shall explain later in greater detail, the growth and deployment of our diplomatic and foreign assistance assets have contributed to major foreign policy successes:

-- The NATO Alliance is strong.

-- Democratic institutions have emerged throughout Latin America and in key countries elsewhere.

-- We have an enhanced security posture in Central America, the Caribbean, and the Pacific Basin.

-- There has been a dramatic shift in Third World economies away from statist solutions and towards free markets.

-- We have maintained the peace process in the Middle East, by an active diplomacy but also by steady support for our friends on both sides who are being asked to take risks for peace.

-- We have given effective support to those who fight for freedom and independence in their own countries.

We must consolidate and expand these accomplishments as we continue to explore new opportunities for peace and stability. To meet these objectives, we have constructed a budget which reflects our essential needs.

Budget Overview

The FY 1987 budget request for the International Affairs Functions totals $22.6 billion: $2.1 billion above the FY 1986 "post-sequestration" levels; $1.4 billion above the amounts appropriated by the Congress for FY 1986; but $200 million below the amounts originally requested by the President for FY 1986. Let me first speak to the two major areas of increase over the post sequestration levels.

The largest increase -- $1.5 billion for the State Department's operating budget -- reflects the Administration's proposals to protect our people and diplomatic posts overseas from international terrorism. We in the State Department and our colleagues from other agencies serving abroad are on the front line. The courage and patriotism of our people and their families in facing the dangers of terrorism are inspiring. We must ensure their safety. The Congress urged us strongly to develop a comprehensive program. We have done so, and are now presenting it to you.

The second major area of increase is to restore security assistance levels necessary to meet our international commitments and to pursue our priority foreign policy objectives. Helping our friends defend themselves is our first line of defense.

As the President said last year, "dollar for dollar, our security assistance contributes as much to global security as our defense budget." We must not succumb to false economizing -- leaving ourselves and our friends more vulnerable in areas vital to international security. Vacuums that we create in countries or regions of strategic importance will soon be filled by those less interested in peace and stability than we are. In the long run, this will end up costing us much more than the short-term investments reflected in this request.

Let me address the major budget components and the objectives they serve. Our Development and Security Assistance requests for $16.2 billion serve four main foreign policy objectives: supporting the Middle East peace process; strengthening our alliances and cooperative defense relationships; promoting regional stability in Central America and the Caribbean; and supporting economic reforms and democratic forces throughout the world. These objectives are interrelated -- and crucial.

Nearly 34 percent of these resources go to Israel and Egypt in support of our search for peace in the Middle East. Assistance to the base rights countries of Spain, Portugal, Greece, Turkey and the Philippines and to military access and front line states such as Kenya, Oman, Morocco, Korea, Pakistan and Thailand represents another 26 percent.

Our efforts to promote regional stability in Central America and the Caribbean take another 11 percent. There are other countries of importance to us which share our democratic values, such as India and Colombia; or where new democracies have emerged, such as Bolivia and Uruguay; or where fundamental economic reforms are taking place, such as Ecuador and Senegal; or that are simply strategically important to us, like the island states of the South Pacific. When these countries prosper and remain free, they demonstrate to the world that the benefits of open societies and open economies transcend geographic size and cultural diversity.

They deserve our moral and material support. The amount of funds we are seeking to support these countries is relatively small -- some 17 percent of the total foreign assistance request. The real and symbolic importance of these resources, however, is considerable.

All other country programs account for only 3 percent of the total foreign aid request. Some are poverty-stricken African states to which we are directing our humanitarian and technical assistance programs. Others, like Mozambique, are moving from the Soviet bloc toward genuine non-alignment. Still others, such as Burma and Peru, are active partners with us in the war against international narcotics trafficking.

Finally, some 9 percent of our assitance goes to AID non-country programs and a number of generously beneficial efforts including the Peace Corps, refugee assistance and narcotics control efforts.

Mr. Chairman, we have done some tough pruning and made hard choices to come up with these allocations. It is a lean budget and, in our considered view, a minimum budget. Further reductions would compound our risks, weaken our friends, and add to our dangers. Foreign assistance is a kind of insurance, shoring up our security. If we try to cut corners, we run the risk of greater dangers that could well exact much higher budgetary and foreign policy costs. If the FY 1987 budget is insufficient, as it is in FY 1986, to fund country programs adequately and to provide the flexibility necessary to meet new requirements in an ever changing world, we deny ourselves the opportunity to build and maintain constructive relationships with dozens of countries throughout the world serving a multiplicity of U.S. interests.

Let me now do a brief tour of the world to discuss the specific policy objectives I outlined earlier.

The Search for Peace in the Middle East

Peaceful solutions in the Middle East will become possible when we and our friends make it clear that radical solutions get nowhere. Our commitment to Israel and her security is rock-solid, and our levels of assistance must reflect that commitment. At the same time, we must continue to provide significant support to Egypt, which had the courage to break ranks with the rejectionists and make peace with Israel. A sound Egyptian-Israeli relationship remains the cornerstone of our broader peace efforts and our regional security policy. We must also help our moderate friends in the Arab world defend themselves against the genuine security threats they face. Radical forces in the region are against negotiations, against peace. Thus they lash out not only at Israel, whom they seek to destroy, but at any Arab country that shows the courage to seek peaceful solutions.

The necessary condition for further progress in the Middle East peace process is the willingness of both Prime Minister Peres and King Hussein to pursue ways to enter into direct negotiations. Both leaders remain fully committed to this endeavor.

Two key issues remain to be resolved: how to structure international support for direct negotiations and how the Palestinian people are to be represented in those negotiations. Prime Minister Peres has accepted the idea of an international forum, and recent discussions with both sides have addressed specific arrangements. The question of Palestinian representation is particularly difficult, confronting King Hussein with the historic challenge of bringing forward Palestinians of good will who will support and associate themselves with efforts to reach a negotiated settlement.

Egypt is uniquely situated to interact constructively with all the parties, and wants to help move the process forward. We value President Mubarak's assistance and support. At the moment, Egypt is engaged in talks with Israel aimed at resolving the Taba border dispute and other bilateral issues, including the return of the Egyptian ambassador to Tel Aviv. We are hopeful these efforts will soon bear fruit.

Syria and Jordan have recently entered into a dialogue on bilateral relations as well as the peace process. Syria remains an important factor in the equation and we are following the course of those discussions with great interest.

We are seeking $5.4 billion in economic and military assistance for Israel, Egypt, and Jordan. We are in the process of reviewing with our friends in the region their needs for defensive arms. Meeting their legitimate defensive requirements is critically important to maintaining the credibility of our security role throughout the region and to preserving our role as mediator in the search for peace. Above all, we must strengthen our friends in order to deny the Soviets any opportunities to subvert a region crucial to our interests.

Israel's Economic Reforms

Last year, we sought, and Congress appropriated, $1.5 billion in supplemental assistance to support Israel's economic reform program. Buttressed by this assistance, Israel has made significant progress in stabilizing its economy since last summer. Prime Minister Peres' July 1 measures included a 19 percent devaluation of the shekel, cuts in government expenditures leading to a marked reduction in the budget deficit, a sharp decline in real wages, and a restrictive monetary policy.

The combined impact of new fiscal and monetary policies on inflation has been dramatic. The monthly rate of inflation declined from 27.5 percent in July to 1.3 percent in December.

This has enabled the Israeli Government to keep the shekel/dollar exchange rate stable. Meanwhile, the positive trend in the balance of payments, which began in late 1983, has continued. Israel ran a substantial civilian current account surplus in 1985 due to continued improvement in its balance of trade and substantial increase in transfers from abroad. This improvement resulted in more than a billion-dollar increase in official reserves, from the mid-year low point, to about $3.2 billion at year's end. Israel's foreign debt stabilized and its maturity structure improved, as short-term debt was repaid during 1985. U.S. economic support funds and disbursements from our FY 85 supplemental appropriation for Israel made an important contribution. The remainder of our supplemental, which was a one-time emergency assistance measure, will be disbursed in FY 86 in support of further Israeli reform efforts.

Notwithstanding the considerable progress made so far, Israel's stabilization program remains fragile. The major problem continues to be excessive government spending. The new Israeli budget moves in the right direction, but additional reductions in government spending are necessary. Recent wage increases are also cause for concern. While real wages have fallen sharply since last July, they are programmed to increase in the December-March period; by April real wages will be where they were last June.

Unless offsetting measures are taken to contain the attendant increase in domestic demand and production costs, wage increases of this size could result in renewed inflation and higher unemployment. Future wage increases need to be linked to increases in labor productivity.

Over the longer term, the government of Israel would do well to consider reforms in a number of other areas as a means of facilitating noninflationary growth. These include delinking financial assets from domestic price indices, labor market reform, and changes in investment and tax policies. Our recent bilateral discussions in the Joint Economic Development Group have focussed increasingly on these and other economic and investment issues in recognition of their importance to Israel's long term growth and prosperity. Our discussions with Israel in this forum underscore our commitment and partnership.

In the context of Israel's economic reform, we strongly endorse Operation Independence, a private sector effort to expand trade, encourage private investment, and reduce Israel's dependence on U.S. aid. Spearheaded by a group of dynamic American businessmen, this initiative has already produced tangible results in expanding Israel's exports.

Egyptian Economic Program

Last year, at the Administration's request, Congress also appropriated $500 million in supplemental assistance for Egypt. These funds, along with our regular assistance program, were in support of economic reform. In 1985, the Egyptian government drew up a 13-point reform program. It raised prices for agricultural commodities, for example, and for a wide range of sensitive consumer items; it also raised electricity rates by more than a third and gasoline prices by 25 percent. These incremental actions, however, still fall far short of the comprehensive effort needed for long-term economic viability.

During 1986, we will time our disbursement of the remaining $150 million of the supplemental to support further reform measures. Priority areas for action include reducing the balance of payments and budget deficits, improving the system of debt management, and expanding the role of the private sector. Rapid progress in these areas is all the more urgent now, given the damaging impact on the Egyptian economy of the precipitous drop in oil prices.

The Persian Gulf

We continue to be concerned and vigilant about the Persian Gulf. Strategically located, this region is vulnerable to Soviet expansionism.

It remains a major source of energy supplies essential to the economic health of the free world. Our naval force in the Gulf expresses our interest in the security and stability of the region.

We and our Arab friends agree that they should be the first line of defense of the Gulf. Thus, our role -- an essential role -- is to continue reinforcing the defensive capabilities and security of our friends in the Arab Peninsula, both through commercial sales and security assistance. The security relationship we have built with Oman is a vital element of our Central Command strategy. Our military assistance to the Yemen Arab Republic, on the other side of the peninsula, is particularly important in view of the recent destabilizing events in South Yemen.

We are troubled by Iran's intransigent prolongation of its brutal war with Iraq, as well as by the dangers which this war poses for nearby neutral countries. We have offered vigorous support for all the numerous efforts, particularly that of the United Nations, to bring the war to a negotiated end with the sovereignty and terroritorial integrity of both sides intact.

Enhancing Defense and Security Relationships

Around the world, America's alliances and security relationships are sound. We have had some differences with our European allies during the past year. But alliances among free nations will always see expressions of differing perspectives. On the fundamental issues of our mutual security, the Atlantic Alliance remains solid. In fact, we made gains in the past year -- for example, in our bilateral discussions about participation in the research program of the Strategic Defense Initiative.

With the Soviet military threat to Central Europe and Southwest Asia continuing to grow, security assistance designed to improve the defense capabilities of countries on NATO's southern flank is of special importance. Our security assistance to key NATO allies also helps ensure continued access to strategically important military bases and sustains confidence in the "best efforts" commitments which are the foundations of our base agreements.

We cannot measure our interests in NATO's southern flank solely by our military links. The broad common commitment to Western values has a meaning that transcends these military ties. Spain and Portugal have now joined Europe, in an important symbolic sense, in joining the European Community.

This is a triumph for the Western world. On the other side of the Mediterranean, we often hear of problems bedeviling our bilateral relationships with Greece and Turkey. Let us not forget the common interests and shared values that underlie these relations and that establish the basis for the resolution of our difficulties. I view my upcoming trip to these two countries as part of the process of building on our common objectives.

On the other side of the globe, we continue to regard the U.S.-Japanese Mutual Security Treaty as the pillar of Asian peace and stability. Japan has become our largest market after Canada, and both sides are working toward resolving our trade differences. We are also working with the Republic of Korea, whose security has never been more important to us, on trade issues and mutual security and resolving market access problems in our expanding two-way trade. While we have some serious problems with New Zealand, Australia remains a valued ally.

Our aid programs concentrate on the region's more threatened or vulnerable nations: the Philippines, the Republic of Korea, and Thailand.

The Philippines is experiencing serious economic and political problems.

Ambassador Philip Habib is currently assessing the situation there for the President, and we expect his report to influence the course of our efforts to assist the Philippines through this prolonged crisis. In the meantime, we are taking care to ensure that our aid contributes to the structural reforms needed to put its economy back on the path of growth. Our military assistance to the Philippines remains our best and most useful tool to help promote the reform and development of a professional military. Whatever the near-term problems of the Philippines, there is no doubt that the presence of a strong, democratically oriented military is in our best interests. It is also time to fund military assistance at a level necessary for the Armed Forces of the Philippines to fight the insurgency successfully. We must also fulfill the President's "best efforts" commitment made in the context of the last five-year review of the military bases agreement. The military facilities themselves remain vital to protecting the sea and air lanes of the region and providing logistical support for our forces in the Indian Ocean and Persian Gulf.

The Republic of Korea continues to confront the greatest threat to its security from its communist neighbor to the north. Tension on the peninsula remains high, and continued American presence and support are crucial, especially over the next three years.

Our Korean ally is already devoting a large portion of its GNP to defense, but continued FMS credits are needed if Korea is to meet key objectives of its Force Improvement Plan.

Like Korea, Thailand is an ally allocating substantial resources to military modernization and creating a credible deterrent to Vietnamese aggression. We need to support these efforts and assist Thailand in achieving its development goals so that it can maintain a healthy, balanced economy in the face of its increasing security needs. We need to do this not only because of the importance of Thailand itself but because we have an enormous stake in the independence, prosperity and integrity of the group of ASEAN nations of which Thailand is a part. The ASEAN nations sit astride vital sea lanes joining Asia with the Middle East and Europe. The United States -- indeed most of the free nations of the world -- have a critical interest in keeping them peaceful and open. Our assistance programs in Malaysia, Singapore, and Indonesia help ensure stability and promote progress.

One very important element in our support for ASEAN is the effort to find a political solution in Cambodia. To this end, we are backing the non-communist Cambodian groups resisting Vietnam's occupation of their country.

Following the Vietnamese offensive a year ago that drove their camps away from the Thai-Cambodian border, these forces have concentrated on regrouping and training for guerrilla activity inside Cambodia.

Together, the Khmer People's National Liberation Force (KPNLF) and the Sihanoukist National Army (ANS) have some 9,000 troops currently operating inside the country, with more scheduled to enter. Despite problems that include a serious split within the KPNLF leadership, military resistance leaders are optimistic about their prospects. We are now discussing with interested parties how the U.S. assistance funds for non-communist groups provided in FY 1986 can best support resistance activities. We do not plan to provide lethal equipment, as the groups are already adequately supplied with weapons.

In the Pacific, we are in the process of establishing a new and unique relationship with the Freely Associated States of Micronesia. In the South Pacific we are facing for the first time the threat of increased Soviet interest and activity. The negotiation of a regional fisheries agreement with the nations of the South Pacific which promotes US interests in the area. We hope to reach a final agreement later this year.

In South Asia, the Soviet aggression in Afghanistan has continued for more than six years. Pakistan's staunch opposition to Soviet aggression and its generosity to more than two million Afghan refugees pose an enormous financial burden on Pakistan, which the United States has tried to alleviate through our current six-year economic, five-year military program of assistance. This program enters its final year in FY-87. We must maintain that support, out of loyalty to a staunch ally that faces a direct Soviet threat, and to maintain the pressure on the Soviets to move toward a negotiated settlement in Afghanistan.

Our assistance provides vital support for Pakistan as that country enters a new era of democratization, which began with the lifting of martial law on December 30, 1985. The new civilian government is looking to the United States, which has strongly encouraged a more representative government, to provide continued moral and financial support as the government copes with the continuing Soviet aggression in Afghanistan and the burden of refugees. Pakistan is a poor country, and our assistance also helps it pursue its economic development plans even under the heavy burdens it bears.

Regional Stability and Security in Central America and the Caribbean

Events in Central America and the Caribbean over the past year have confirmed the important link that exists between foreign assistance and U.S. national interests. Our continuing policy of support to pro-democratic forces is enabling democracy to take root and to become self-sustaining.

Guatemala is the latest Central American country to have abandoned military rule for elected civilian government. Elected civilian leaders also have replaced authoritarian regimes in El Salvador and Honduras. Nicaragua is the only non-democratic country remaining in that region.

A few years ago, critics of Central America and U.S. policy toward that region were skeptical that democracy could gain support in an environment where history and economic hardship seemed to impose such burdens. They are less skeptical now. They have seen the people themselves, in one free vote after another, demonstrate their belief that democracy is the road to a better life for themselves and their children. They have also seen that our moral support and economic and security assistance can help make the difference between the success and failure of this democratic experiment.

If we truly believe in human rights and economic and social progress, we must keep that lesson in mind as the peoples aspiring to freedom turn to us for support in the coming months.

The most immediate danger to democracy in Central America, of course, is the assault on it from Communist Nicaragua, aided by Cuba and the Soviet Union. Democratic El Salvador is an outstanding example of a country that has managed to withstand a communist insurgency, and we have been privileged to play a part by our encouragement and help. So our policy -- if we keep at it -- is working. All the democracies of Central America look to us for help in defending themselves. We must support them. And we must support, not abandon, the democratic resistance within Nicaragua, which we support for both moral and strategic reasons. We will be discussing with the Congress what this moral and strategic imperative requires.

The Caribbean too is fertile ground for democracy. Cuba is the most egregious exception. In Haiti, after decades of autocratic government and a stagnating economy, the people have new hope of seeing a government responsive to their needs and aspirations. Our policy toward Haiti is the same as our policy toward the rest of the hemisphere. We seek to promote progress toward democracy, greater respect for human rights, and rapid and equitable economic growth.

We feel that the Haitian people should choose their own future and we note that the new government has committed itself to this objective. We hope to be of help as the interim government goes forward with this effort.

On the economic side, the Caribbean Basin Initiative is succeeding in broadening and diversifying the production and export base of the region, laying the foundation for long-term recovery. Unfortunately, many of the gains have been offset by declines in the prices for traditional exports. In some cases, most notably sugar, the declines in prices are aggravated by our farm bill which will result in a loss of $52.0 million in export earnings by the Caribbean Basin countries. The restructuring of economies to make them less vulnerable to commodity price fluctuations requires a sustained commitment from the political leadership of these countries. It also requires sustained support from the international development community. We will continue to do our share.

Supporting Economic Reforms and Democratic Institutions

Looking beyond Central America and the Caribbean, across the globe, we see further evidence of the powerful appeal of liberty. Democracy is taking root in country after country, demonstrating the vitality and relevance of our ideals.

The past few years have also confirmed the connection between freedom and economic progress. In the early 1980's, this Administration developed economic policies aimed at liberating the creativity of the American people. The results speak for themselves: 9 million new jobs in this country in the last three years, helping pull the world economy out of recession, with inflation now one-third the rate of five years ago.

The world economy is still troubled. But nations everywhere are re-discovering the basic truth that the source of economic growth is individual creativity, not the state. The same laws of economics apply to developed and developing countries alike, and those that apply its truths are reaping the rewards.

India, the world's largest democracy, is a critical -- and successful -- test case that shows that democratic politics and economic development are not only compatible, but mutually supportive. Under Rajiv Ghandi's able leadership, India is moving into an era of advanced technology and rapid economic growth, spurred on by the liberal economic policies. It is not only an increasingly attractive market for American exports, but is becoming a major factor in such areas as computer software and light industrial goods.

India has also assumed an increasingly important strategic role, as it takes place as a major regional -- and world -- power. It has begun this process by strengthening its ties with its regional neighbors, especially Pakistan, with which it has announced a major nuclear agreement. Our own relations with India have significantly improved this past year, and not at the cost of our ties to China and Pakistan.

In Argentina, Brazil, Ecuador, Uruguay, Bolivia, and Peru, democratic governments are faced with the daunting challenge of restoring economic stability and establishing the conditions for sustained economic growth. The task for the Andean countries is further complicated by narcotics trafficking and terrorism. In Colombia, one of the oldest democracies in South America, terrorists and narcotics traffickers are threatening to undermine years of economic growth and progress. We want to help Colombian efforts to meet these threats. To do so, we are seeking modest increases in our security assistance program.

In Peru, a ruthless terrorist organization and a well-entrenched narcotics industry threaten national stability. We applaud President Garcia's commitment to stamp out narcotics trafficking and his determination to end terrorism within the context of democracy and respect for human rights.

A mutually constructive relationship with Peru, however, will require greater moderation and cooperation and meaningful economic reform by the Peruvian government. If these actions evolve as we hope, we would need to find increased resources to support the Peruvian effort.

In Africa, young and fragile governments are struggling with the most profound economic crisis in the continent's modern history. Our adversaries have shown themselves willing to take advantage of the continent's plight, exploiting political-military conditions in such disparate areas as southern Africa, Chad, and the Horn. It is in our own interest to help Africa realize its potential: to fuel economic growth; to monitor and thwart the actions of Libya, the Soviets and their surrogates; and to encourage adherence to improving standards of human rights.

Last year, the world witnessed the devastating effects of the drought which put over thirty million Africans at risk of starvation. The American response was extraordinary. Our government and private sector contributions provided unprecedented levels of food, as much as the rest of the world combined. The combined effort saved countless lives and we can be justifiably proud of the results.

For the long term, we must encourage Africans themselves to promote the policies that lead to agricultural productivity, economic growth, and stability. There is cause for hope. Some African countries are starting to reject the statist economic policies which proved so disastrous, misallocating scarce resources and discouraging the productive private sectors of the economy.

Our bilateral AID programs are increasingly stressing policy reforms that stimulate private sector productivity. The African Economic Policy Reform Program (AEPRP) made good progress in 1985 in promoting market-oriented reforms in Malawi, Mali, Mauritius, Rwanda and Zambia. This year, we plan to start implementing the President's Food for Progress initiative, which will concentrate on reforms in the agricultural sector needed to provide farmers with adequate incentives.

Diplomacy in Southern and South Africa

Turning from purely economic to more general concerns, no region of Africa is the cause of more debate and concern, both in the United States and abroad, than southern Africa. We are committed to playing a positive role as the region grapples with the twin challenges of containing regional strife and bringing the abhorrent system of apartheid to an end.

In the regional conflict, our aim is to show that military solutions will not work. Unfortunately, the Soviet Union and its Cuban and Angolan allies still have illusions on this score. Over the last two years, the Soviets have delivered an extraordinary $2 billion in military equipment to the regime in Luanda, and have engaged themselves directly in the fighting. The visit of Jonas Savimbi to this country should make clear America's determination to ensure that no outside power will be allowed the opportunity to resolve, on the battlefield, the civil war that divides Angola. At the same time, we search for a negotiated solution. As long as negotiations continue, the path lies open to a settlement which would lead to the independence of Namibia and end the intervention of all foreign military forces in Angola.

We are particularly pleased by Mozambique's substantial move toward genuine non-alignment. This is reinforced by major new aid commitments from the West, of which our own aid program is an integral part. We want to encourage this favorable trend. I am concerned that the Congressional restrictions on aid to Mozambique threaten to undo what has been a significant political accomplishment of U.S. foreign policy.

In South Africa, the goal of reform must be to end apartheid and to bring about a political system based on the consent of the governed.

The President's Executive Order of last September 9 was designed to convey the united opposition of the American people to the apartheid system. This is a message we continually reiterate in contacts with the South African government. It is also a message we are sending in concrete ways, as we move to build ties with the black community in South Africa. The aid program mandated by the Executive Order works through private voluntary organizations to train black leaders for the future and to assist black entrepreneurs. We are also providing funds for direct legal assistance to the victims of apartheid and their families. The Human Rights Fund will provide $1.5 million for these and similar projects while about $10 million will be available for scholarships for those disadvantaged by apartheid.

America continues to play a positive role in South Africa, but outside countries cannot, alone or in combination, resolve South Africa's problems. The government there must take the steps that will make it possible for black leaders to negotiate. In turn these leaders must be willing to negotiate themselves. The alternative is the kind of violent upheaval that seldom produces just or democratic solutions.

Multilateral Development Banks and Programs

The Multilateral Development Banks play an important and complementary role in many countries important to the United States. As developing countries seek to move from crisis management and austerity to a renewal of sustained economic growth, they will be competing for a finite supply of investment capital from the international financial community. These resources will flow where they are welcome -- when conditions are hospitable. A true partnership based on mutuality of interest will have to be forged between the developing countries and the holders of development capital -- the industrial countries, international lending institutions, and the commercial banks.

Last October, at the Bank-Fund meeting in Seoul, Secretary Baker proposed a bold, new comprehensive approach to get debtor countries back on the path of sustained growth. The proposal envisaged a more vigorous World Bank role in facilitating and promoting economic reform and adjustment in debtor nations, as well as greater coordination between the Bank and the IMF in their country programs. The proposal also included a provision for enhancing World Bank and IMF cooperation in providing concessional financing to the poorest developing countries, most of which are located in sub-Saharan Africa.

When Secretary Baker outlined our approach, he stressed that the sine qua non of any comprehensive strategy was a more focused and determined effort of market-oriented structural reform aimed at greater efficiency, more domestic saving, and a more attractive climate for domestic and foreign investment. And, in conjunction with this, he addressed two other key elements designed to provide outside support and encouragement for structural reform: more substantial and better-coordinated assistance from multilateral institutions, and more support from commercial banks.

This was a creative effort, it seems to me, to bring the broader international community into the process of helping solve the debt problem. Both the World Bank and regional development banks are well placed to complement the continued central role of the IMF by providing financing and advice to countries taking the essential steps toward structural reform. The World Bank's considerable expertise can help devise programs for growth through structural reform. It can support these programs through increased lending to promote reform in inefficient sectors of the economy, and through increases in policy-based lending. The Inter-American Development bank is uniquely situated to help in this effort, as well, but improvements are needed in its institutional capabilities before this potential can be fully realized.

Our participation in the multilateral development banks is an integral part of our assistance policy. Continued Congressional support for our replenishment commitments will sustain our leadership role in these institutions.

The new commercial bank lending that Secretary Baker proposed -- $20 billion over a three-year period -- is also a vital part of the near-term effort. Bank lending to the principal debtor countries has been declining, with very little new net lending having taken place in 1985. Increased lending can provide important support for policies to promote efficiency, competitiveness, and productivity -- the true foundations of growth. Such lending, however, will only be forthcoming if there is a clear commitment to adopt and implement such growth-oriented policies.

In Seoul, Secretary Baker also proposed that the World Bank, IMF, and other donors develop joint programs to support medium-term structural adjustment in the world's poorest countries. Africa will be the chief beneficiary. The proposal calls for the coordinated use of $2.7 billion in IMF Trust Fund reflows World Bank funds, IDA monies, and possible increases in bilateral contributions for Africa to support comprehensive economic reform programs.

This proposal merits our full support as the development of consistent and coherent country economic reform programs is essential if we are to maximize the efficient use of scarce development capital.

The need for increased coordination between the Bank and Fund has been generally supported; and the U.S. initiative is gaining broad acceptance. We have addressed the concerns of Fund and Bank members regarding the need not to blur the distinctive roles of the two institutions while achieving closer cooperation and collaboration.

I do not want to leave the subject of efficient use of development capital without commenting on the need of the developing countries to take full advantage of the opportunities of the world trading system. This is essential if they are to achieve their great potential for expansion of output and export earnings.

Restrictive trade practices have only compounded the problems of many heavily-indebted developing countries. All too typically, heavy foreign borrowing has supported fiscal deficits and overvalued exchange rates, putting a great burden on export competitiveness. Import barriers have been erected to protect favored domestic industries from foreign competition.

These barriers have severely hampered the growth of trade among developing nations. The developing countries and the industrialized world have one thing in common: all of our peoples are winners if we have a stronger and fairer world trading system. We hope the developing countries will work with us on a new trade round to overcome the narrow interests that threaten our common progress.

The Battle Against Terrorism

I would like to conclude by elaborating on my earlier comments about the requested increase in our operating budget.

Over the past few years, the world's attention has been riveted to terrorist dramas unfolding around the globe. I have spoken frequently on this subject. Civilized nations and civilized peoples have been inadequately prepared for it. That can and must change. We must do everything we can to thwart those who seek to advance their ends through terror and to ensure the safety of our citizens abroad. Even in this period of budgetary stringency, this task must be a priority. We have designed a program which in our view is prudent and efficient in its commitment of resources, yet responsive to the inescapable necessity we now face.

The United States has always built handsome and accessible embassies and consulates abroad. Our object was to demonstrate to other societies the openness of ours and the hand of friendship we extend to all. We wanted other societies and their people to see a "welcome" sign above our door and to feel comfortable in entering our buildings. This is the essence of the job we do overseas, and we have been highly successful at it. We are now faced with a new situation: The current security and terrorist problems have left those same buildings vulnerable. Our challenge is to strengthen our security against these new dangers so that we can maintain our tradition of openness and accessibility. We will not let the terrorists win their victory by isolating us, forcing us to close our doors, or denying us our contacts with the people of the countries in which we are represented.

With this goal in mind -- and knowing of the great concern in the Congress -- I formed the Advisory Panel on Overseas Security, chaired by Admiral Inman. I asked the Panel to take a hard look at our security and counterterrorism programs.

The hard work and dedication of the Panel is clearly reflected in the quality of its report. The Panel exhaustively researched all aspects of our security and counterterrorism programs. Its recommendations have vision.

Equally important, they are practical. They are recommendations which, with your support, we can act on.

The Panel made 91 recommendations. We have implemented 45 and work is under way on 20 more. An additional 20 are awaiting the resources requested in our proposed authorization and appropriation legislation.

Using existing resources and authorities that the Congress has already provided, we have made progress in many areas highlighted by the Panel. For example, we have:

-- started an ambitious recruitment campaign to bring on board nearly 300 new security agents during FY-86 and to more than double the number of overseas security officers before the end of this fiscal year;

In addition, we have:

-- added more Marines to posts;

-- nearly doubled the size of our armored vehicle fleet worldwide;

-- made significant physical security improvements at 152 of our posts overseas in 1985;

-- consolidated the security functions of the Department into one office, the new Bureau of Diplomatic Security; and

-- also created an Office of the Ambassador-at-Large for Counterterrorism, which deals with policy matters and reports directly to me.

There is, however, a limit to what we can do with existing resources. We need additional legislative authorities and resources to implement some key recommendations of the Inman Panel. We are seeking a significant part of the total resources in FY 1987.

The Administration's proposals will do three main things:

-- First, launch a comprehensive worldwide security program, key elements of which are improvements in communications and intelligence sharing, and a five-year construction program to replace or upgrade our most vulnerable posts;

-- Second, complete the reorganization of our security program as recommended by the Inman Panel; and

-- Third, revise and clarify the chain of command for overseas security programs.

The program places its highest priority on buildings at locations where the security threat is greatest and which are substantially below the new standards.

Great effort has gone into creating a security construction program which would ensure that buildings are designed and built to meet stringent security standards, on time and within budget.

But our proposals are more than a security construction program. We will also improve communications and counterintelligence. For example, we will improve security at Moscow and other East European posts by substituting Americans for a substantial number of local employees now working in support positions.

Further, we are requesting resources to strengthen our capability to protect foreign missions and dignitaries in the United States.

We are working closely with other agencies to develop and agree upon appropriate security standards, procedures, and levels of resources responsive to the needs of all U.S. government agencies having facilities overseas (other than military bases).

We are requesting $4.4 billion spread over five years. Of this total, $2.7 billion is for construction, and the balance is for operating expenses, including security officers, residential security improvements, and more secure communications equipment. In FY 86 the Administration is requesting $237 million for salaries and expenses and $455 million for construction. In FY 87, the request is $304 million for salaries and expenses and $1.1 billion for construction.

The Administration's proposed program will not solve all of our security problems. But we can minimize them. Our proposal is a comprehensive -- and long overdue -- security program which addresses our most basic security concerns.

Conclusion

In summary, Mr. Chairman, the world remains a turbulent and sometimes dangerous place. But as we look ahead, we draw strength from our ideals, from our friends and the young democratic nations who have joined our ranks and now look to us for support. America remains a beacon to the freedom-loving peoples of the world. Powerful trends are the side of freedom. That is one of the lessons of 1985.

Another major lesson of the recent past is that realism, strength, and staying power are crucial prerequisites to meeting these international challenges. History won't do our work for us. We have to be worthy of our opportunities.

The President has observed that the responsibility for the economic health of our country does not reside with one branch of our government nor with one political party. The partnerships that must be forged to deal with the federal budget deficit are also critical to meeting the challenges we face in the international arena, many of which directly affect our national security.

The noble tradition of bipartisanship, which brought us so many dividends in the postwar years, does not ask any of us to abandon our principles. But it does require all of us to recognize how much harder it is to meet foreign challenges if we are not united at home. In recent years, we have seen signs of a rebirth of the postwar national consensus -- based on a realistic understanding of the world as it is, and of the need to negotiate differences where possible. The President has asked me to reiterate his commitment to work in a bipartisan spirit with all members of the Congress on behalf of the peace, freedom, and security of this country.

Chairman **Domenici**. Since I can be here throughout the entire morning, and some Senators are having difficulty with it, I will reserve my questions until a later time and yield to Senator Kassebaum to start on our side.

Senator **Kassebaum**. Thank you, Mr. Chairman.

EARMARKING OF FOREIGN ASSISTANCE FUNDS

Mr. Secretary, you mentioned earmarking and since, I believe, about 41 percent of the budget goes to Egypt and Israel and another 18 percent, I believe it is, goes to the five base rights countries, that means approximately 60 percent is given to seven countries. Would you favor ending earmarking?

Secretary **Shultz**. I think earmarking is a legitimate expression of congressional determination, but when you have the proportions and the detail involved, it reduces our flexibility tremendously. And we can feel it when, for example, we were applying the cuts that were our share of the $11.7 billion just recently. And it is just painful to know where you can cut.

I was interested, in spite of the earmarking and in spite of the fact that our payments had already been made to Israel, that as they saw the across-the-board cuts being applied, they volunteered to have those cuts apply to Israel as well, which I think is a recognition of the budget stringency that we face. But I do think the earmarking does impose a severe restriction on us—but by and large, the allocations that are made are ones that we support.

Senator **Kassebaum**. Well, it has always troubled me regarding the funding that comes for Africa, of course, which is only 7 percent of the total, I believe, of foreign aid. In Ambassador Kirkpatrick's piece, she particularly points to the African aid, and it is true—within a very small percentage, we have to be careful of the priorities. But at this particular time, it does seem to me that it places constraints on decisions, with the earmarking that at some point was established, that really makes it very hard for us to work with the policy flexibility that I believe is important.

But I do not know that that is anything we are going to change. I would wish we could.

Secretary **Shultz**. Well, it certainly should not be changed further in the wrong direction, as Ambassador Kirkpatrick seemed to suggest in her article. I noticed the chairman quoted her article five or six times in his opening statement and put it in the record.

One of Ambassador Kirkpatrick's outstanding characteristics is that she loves debate and criticism, and so she has given it to us. But I would have to say that I do not agree with her article and I am ready to discuss the items that you raise.

Insofar as too much aid going to sub-Saharan Africa is concerned, we have to recognize that the per capita income of those countries is the worst anywhere, and the programs that we have underway are directed primarily to agriculture, and are directed primarily to helping them change their method of managing agriculture in a more private incentive way, and as these lessons are applied, they are working. And we think in addition to the outpouring of support for hunger caused by drought, we have an obligation in this country to point out that part of the hunger is caused by mismanagement, and there are ways to improve it. And a good part of our program is designed to help them find those ways, and I have no apologies to make for it—in fact, I am proud of it.

Senator **KASSEBAUM**. Well, sub-Sahel Africa is a matter of great concern to all of us who have been engaged there. It is troubling to me that we have spent, I believe, about $750 million over the last decade, and we still, of course, are facing ever-worse conditions.

SECURITY EFFORTS

It goes back again to how exactly those programs are targeted. But I would like to ask you regarding the security efforts in the particular budget priorities, and again, regarding Africa.

I have found it difficult to understand why—if this is correct—$35 million has been targeted to the Embassy of Benin, at which there are seven people.

Now, is there some rationale for why Benin at this point should have such elaborate security precautions?

Secretary **SHULTZ**. It represents a very good issue for discussion here, and it may be that that is a wrong allocation. But in a sense, in a place where there is a considerable threat, there is a certain minimum that you need to have for security purposes and for secure communications so that you do a proper job of counterintelligence and so on. And in Benin, you really have to start from scratch and build something if we are going to have something adequate.

Now, perhaps what that should tell us is that we should not aspire to have as much of an Embassy there as is envisaged by this program.

So, all I am saying is that we have decisions to make here about where we want to be represented, and where we are represented, then how much in the way of our normal reporting and secure communications and counterintelligence and so forth needs to be included in that structure and those arrangements. And Benin offers a good case study for that.

It is very expensive to build a proper kind of building. It is much more expensive than if you just build a normal commercial structure because of what you have to put into it.

Senator **KASSEBAUM**. Well, I am sure that is true, but again I think it is going to be very hard for us to sell and justify this kind of expense. I certainly agree with your position on the terrorist activities. Many times, it has far more to do with our will and commitment and determination to follow through than maybe some of the cement blocks and elaborate structures, and I think it will take careful evaluation, I would say, Mr. Secretary, if we are going to have to go to our constituencies and sell that kind of increase in a foreign aid budget.

Secretary **SHULTZ**. I agree that the structures and all of the physical arrangements and so on do not provide by any means a complete answer. I think they are a necessary thing for us to do, but not sufficient. And it does seem to me that just the consciousness of the people, of the security problem and adapting to it, is a very important element. And I have had the experience, as you probably have, too, of seeing industrial plants or construction jobs that basically are much the same in terms of their physical characteristics, where the safety record will be sharply different. And you look into the reasons for that, and the reasons have entirely to do with the amount of emphasis put by management on safety and the consciousness that that gives to people. And the same thing is true in the security field, and we need to work all of these fronts at once; I agree with that.

Senator **Kassebaum**. Thank you. My time is up.

Chairman **Domenici**. Thank you very much, Senator.

Senator Chiles?

EXPORT FINANCING

Senator **Chiles**. Mr. Secretary, I understand you have endorsed the administration's proposal for a $300 million war chest to help export financing. That is a proposal I am particularly fond of, having proposed $1 billion war chest last year to serve as a deterrent to predatory financing practices in foreign countries.

I am concerned whether a one-time $300 million sum is totally inadequate to meet either the true export financing needs or to serve as a deterrent. And I am more disturbed to find that the administration only expects to outlay $16 million from the war chest in 1987.

Do you believe that the $300 million is adequate to make a real dent in unfair trade practices. Is it realistic to expect that only $16 million would be spent in fiscal year 1987?

Secretary **Shultz**. What will be spent, of course, depends upon the nature of the problems that the administration of the fund has to face.

I think it is a good place to start, and one thing for sure is that it has caught people's attention, and they are objecting to it. So that in itself is a good thing. So we will just have to see where we get with it. But I think the concept is there, and it is part and parcel of an overall effort to say that we believe in trade that is free and open and fair. And if other people are going to engage in things that we think are unfair by our standards, we are going to hit back. And this is an example, and I hope it works.

Senator **Chiles**. Well, in 1984, France alone spent $1.4 billion on mixed credit financing, and that is what concerns me, whether $16 million is going to compete with $1.4 billion.

What we are talking about here, of course, is that if the United States shows it is willing to participate in this game, and that we will be at the table—if it is a table stakes game, we will be there. We will pull out our poke, and we will play with anybody then. We know that there will not be any real reason for other countries trying to participate in these practices. We found that out a little bit, I think, by some efforts that you had with France in regard to grain shipments to Egypt.

So I think that the question is, does it look like we are willing to be a full player in the game if our ante is only $16 million.

Secretary **Shultz**. Well, our ante is $300 million. We do intend to be a full player in the game, and we are serving notice of that, and if it turns out that the stakes on the table require us to increase our ante, we will be prepared to do that.

Senator CHILES. Good.

Secretary SHULTZ. And I can assure you from the standpoint of the State Department that we are fully in support of actions along these lines.

Senator CHILES. Good. I think that is the signal we need to send and I am delighted to hear that.

Chairman DOMENICI. Excuse me, Senator Chiles, would you just let me make a procedural observation?

Senator CHILES. Yes.

Chairman DOMENICI. Mr. Secretary, I believe it would be all right with the committee with reference to matters that you might want to seek specific advice from your experts, if you do it either by yourself seeking it, or by seeking permission for them to answer the questions; whichever you prefer is satisfactory to the committee.

Thank you, Senator Chiles.

Secretary SHULTZ. I appreciate that reprieve, and I will now act as a kind of shuffler here and tell them they had better be alert.

OIL PRICE FALL HURTS MEXICO

Senator CHILES. Mr. Secretary, the recent decline in the price of oil is certainly going to have a favorable impact on the economic growth and inflation in the United States. We see some other problems on the other side of the coin, especially in Mexico. The question is, will Mexico have the ability to deal with its debt crisis. There have been major demonstrations calling for some kind of a moratorium on interest payments of the debt. Several ideas have been floated for helping Mexico. Obviously, as they say, there is "no free lunch." One option would be to buy more Mexican oil; another would be to coordinate another rescheduling of the Mexican debt.

Is it your perception that Mexico is on the verge of another economic crisis? Should the U.S. actively intervene to assist Mexico if that event occurs?

Secretary SHULTZ. Certainly Mexico has been hurt by the decline in oil prices, and their financial situation, which was difficult even on the assumption of prices somewhat in excess of $20 a barrel, is made more difficult by the lower prices. That is the fact.

Insofar as our attitude is concerned, it is certainly one of wanting to work with the Government of Mexico to find constructive solutions to their problems. Their problem is also our problem. So we want to do that.

Just exactly what in the current situation needs to be done additionally, we have not decided, although we are working on it, and we are consulting some with the Government of Mexico and expect to consult very intensively with them.

OIL PURCHASES FROM MEXICO

As far as the purchases of oil are concerned, our strategic petroleum reserve is pretty well-filled now. The actual spaces are about filled. And in terms of the goal, while the goal in terms of barrels is short of the original goal, in terms of number of days' supply, it is in line with the original goal. So I do not know quite where those oil purchases would come from.

Senator **Chiles**. We are having a little discussion up here as to whether we are ahead of our goal or behind it, I think we have kept cutting the goal back. I guess if you say we are satisfied to have one-half million barrels then we are doing fine.

STRATEGIC OIL RESERVE

Senator **Johnston**. If the Senator would yield, the administration keeps deferring the money for the construction of both the storage facilities and the purchase of oil, and if you cut those back, sure, you can say we have met our goal, because the administration will not accept the congressional goal.

Secretary **Shultz**. Well, let me explain to you our point of view if I can—and I do not have all the numbers right in my head here. That is not a subject that I follow.

Chairman **Domenici**. Neither do all of us.

Secretary **Shultz**. But a goal was set in terms of quantity of oil, and that was calibrated so that it would serve to supply the United States, to replace oil that we would import in case those imports were cut off. Since that goal was set, our consumption of imported oil due to conservation efforts has declined. And so if you say you want the same number of days, so to speak, of protection, you can do it with a smaller volume of oil. And calibrated according to the number of days of protection, the present levels are adequate, although it is, as you say, below the original quantitative goal that was set.

Senator **Chiles**. Well, when we started off we were going to have a 6-month supply of oil, as I recall. Then we set that to 90 days. And what we have got on hand now and the way we are going now is probably 2 weeks or something. And here, we are finding oil at the lowest price we have ever found it, and we are not taking advantage of that bargain to fill the reserves.

Senator **Hart**. And imports are going up, not coming down.

Chairman **Domenici**. Senator, the Strategic Petroleum Reserve is indeed an international issue. Let me say, however, that is one source of international funding that Secretary Shultz is not responsible for.

Senator **Chiles**. Well, I did not raise the issue. The Secretary started talking about it.

FAVOR STRATEGIC PETROLEUM RESERVE

Secretary **Shultz**. I am in favor of the Strategic Petroleum Reserve and was around here when it was originally thought up, and I think it has stood us in very good stead. And 1½ years or so ago when we had the big tanker war in the gulf, the fact that we had an ability to sustain a total cessation in the flows of oil from abroad put our bargaining posture in very good stead. We had a very strong hold card, and everybody knew it, and it helped us in our diplomacy. So I think it is a very good thing to have done, a good investment.

SECURITY PROBLEM FOR FOREIGN BUILDINGS OFFICE

Senator **Chiles**. Mr. Secretary, in your prepared statement, you talked about the increase you are requiring of $4.4 billion for the Embassy Security Program. I happen to be one of those people who has encouraged you to strengthen and go forward with this task. I think that there is strong support in Congress for that.

I am concerned that on a sizable management task like this, whether the Foreign Buildings Office is prepared to handle this kind of money. Can the program be implemented through that office.

Secretary **Shultz**. There is obviously a big management job to be done in running this much construction. So we are putting in place a system for doing it that will go out for bids and have strong American architect/engineers and construction companies take part in the management of the program and give us that expertise. And it is a good thing for us that there are quite a number of companies that are quite experienced all around the world and can undertake this well.

If you would like, I could ask Under Secretary Spiers, under whose jurisdiction this program will come.

USE CORPS OF ENGINEERS TO COORDINATE FOREIGN CONSTRUCTION

Senator **Chiles**. Well, let me just pose another question before we call on him; I would be delighted to hear from him.

When the Saudis were going into a major building program and they sought our assistance, a lot of those dollars were going to be spent in the United States. We used the Corps of Engineers as a coordinating force. Why not use the corps in what you are talking about now?

Secretary **Shultz**. We are making very heavy use of the Seabees as the Government construction organization that we have been working with in our embassy upgrades. However——

Senator **Chiles**. Well, I am not talking about construction. I am talking about the management.

Secretary **Shultz**. However, from the standpoint of management, the corps has played its part in the big overseas construction, but mostly that has been by private enterprise. And with all due respect to Government management, I think the private sector on the whole does it better. So we will look to that.

Senator **Chiles**. Well, to do the construction, I agree with you. I would like to see that be competition and be done by the firms. But the corps was the coordinating force to arrange the bids, to set up the procedure, to oversee some of the contracts.

If we thought that was good enough for the Saudis, or a good way for them to protect their money, why aren't we thinking about that now, when we are talking about protecting our own money?

Secretary **Shultz**. As I said, the Saudis use the corps, but they also use private construction and architect/engineers. I am very familiar with the way they went about some of their very largest projects, such as Jubail, such as the Rhiat Airport, and so forth.

So I think that we are putting in place a management structure—agreeing with you that just to keep doing business in the old way, given the size and ambition of this project, would not be facing the reality, and so we are facing it, and perhaps Under Secretary Spiers could say a little more about it.

Under Secretary **Spiers**. On the question of the use of the Corps of Engineers—and the Secretary has essentially answered that—we have had substantial numbers of discussions with representatives of the corps and have concluded that there really is not much point in putting another Government bureaucracy between us and the private sector on which we are going to rely to do this job.

FOREIGN BUILDINGS OFFICE ABLE TO DO JOB

So far as the FBO is concerned itself, we of course initially had the same reaction as you did, that an organization that was used to a very leisurely pace, that had essentially been run by architects and nonprofessional people would have a hard time doing this job.

We have put a lot of effort and a lot of our personnel resources into preparing FBO to do this job. It is going to have to rely heavily on the coordinating help of the private sector. But I have no doubt that under its new management and under the new systems and technologies that are being developed in FBO, that we are going to be able to do as good a job as the Corps of Engineers could do.

HAVE DOUBTS ABOUT FBO ABILITY

Senator **Chiles**. The only difference between me and you is I have a lot of doubts as to whether you can do it. I hope we do not end up with a bunch of scandals in a program like this.

I will yield, Mr. Chairman

Chairman **Domenici**. Senator Grassley?

U.S. TREASURY AND THIRD WORLD DEBT FINANCING

Senator **Grassley**. Secretary Shultz, I would like to followup on a point that Senator Chiles made about the current situation regarding the downturn in oil and the precarious economic condition that puts certain Third World nations in.

My question is an extension of where Senator Chiles left off. Considering the fact that we are working on the 1987 budget now—that will end September 30, 1987, so we are looking ahead about 18 months—would you anticipate in the next 18 months that there would have to be help from the Federal Treasury in regard to the turnover of some debt of these underdeveloped nations, something similar to what we did in 1983 through the International Monetary Fund capital supplement?

Secretary **Shultz**. I think we should be giving good support to the international financial institutions—the IMF, which we did support; the World Bank; the Asian Development Bank; the African Development Bank. These are good institutions, and we pool our resources with others. And we believe they can play a constructive role here.

The initiative that Secretary Baker put forward in Seoul, and which is associated with efforts announced as a result of the G-5 meeting and which also have their association with our efforts to stimulate a new GATT round, together represent a strategy here.

And the strategy envisages a more aggressive role for the World Bank along with the IMF in addressing the problems of the debt-ridden countries.

GROWTH ANSWER TO DEBT PROBLEM

Now, our presumption is that the basic answer to the debt problem is growth. And if the economies are growing strongly, then they can service their debt. If they are not growing strongly, they cannot service their debt.

So what you have to have is some policies that stimulate growth. And that involves primarily, in our view, adopting the kind of internal structural arrangements in an economy that will produce growth. Then it is possible to think that added debt resources will help.

But absent the structural reforms, having more debt is hardly the answer to too much debt. So we have to do the things that will stimulate growth, and the Baker Initiative basically pushes in that direction.

ARE PROBLEMS FOR DOMESTIC BANKS ANTICIPATED?

Senator Grassley. I want to question further. The Baker Initiative really came before anybody anticipated—I think it was announced in September—and it really came before the tremendous drop in oil prices. So, it seems to me that 4 months later, there may be a little different situation now than then. So I am asking whether there is any anticipation of greater help needed. And, remember that there is a domestic concern about the problems that might be created for domestic banks in this country because of the rollover problem of the debt of foreign nations. We may be called upon to respond to like we did in 1983.

So, I guess I am reading that you do not anticipate at this point that between now and the end of 1987 that there would be necessity for an outpouring of taxpayers' money to repeat a situation we had with the IMF situation in 1983; right?

Secretary Shultz. Let us bear in mind that the fall in oil prices hurt some countries, and we have particularly identified Mexico—there are others. But it also helps countries. So in terms of the overall developing country debt structure, there are pluses and there are minuses. And what we have to do is address ourselves to the places that are hurting the most and help them stay on an even keel.

As far as our banks are concerned, where they have made private loans either for energy-related loans in our own country or to other countries, I think their stockholders basically have to stand up. And for that reason it seems to me that the efforts by banks to enlarge their loan loss reserves are essentially constructive, and my only question would be—and I do not pretend to be real close to this in my own work—but my only question would be whether or not they are creating loan loss reserves at a rapid enough rate.

FOREIGN POLICY TRADEOFFS OFTEN TOO NEGATIVE FOR AMERICA

Senator GRASSLEY. My last point is not a question, but a pleading. It deals entirely with a different matter. But consider that foreign policy decisions sometimes have a very negative impact upon the plight of agriculture, and agriculture is in a very serious economic condition in the Midwest—maybe all over the country, but of course, I am from the Midwest and naturally feel it is worse there—and I would say that a particular instance happened recently in which we were trying to limit ethanol coming into the country, and we had an amendment on the farm bill, and your Department objected to that, in a formal letter from you.

Now, I do not find fault with the rationale you used in your letter, because you were saying that we had certain Caribbean Basin Initiative goals that we wanted to seek, and your pursuit of those is legitimate.

But I do plead with you to consider that there are fallouts that are costly to the taxpayers as well. We can very definitely see the cost to the taxpayers of our country when a certain amount of corn will not be used to produce ethanol in this country when it comes in from Brazil. This results also in a cost of several hundred millions of dollars to the Commodity Credit Corporation, in turn costing the taxpayers of America for our foreign policy initiative.

It is easy for people in one department to say, "Well, we have got these obligations, and if we do not do these things, it is going to cost the taxpayers so much money and more foreign aid."

There is a tradeoff to that, and that tradeoff is, in this specific instance—this is just one of many that I would like to have you consider, but I do not have time to go on. There is a tradeoff and foreign policy very much sometimes affects the food policies, the agricultural policies, of this country, and sometimes, too negatively.

Thank you.

Secretary SHULTZ. Thank you.

Chairman DOMENICI. Thank you, Senator.

Senator Moynihan.

Senator MOYNIHAN. Mr. Secretary, we welcome you, as always, and thank you for your testimony.

May I say I wish I could be as hopeful about your budget as you are required to be and I would want to be. You may have seen in this morning's Post the reports of yesterday's testimony by Rudolph Penner, who is the head of the Congressional Budget Office. He said that if automatic cuts under Gramm-Rudman-Hollings are triggered in fiscal year 1987, the defense program will be cut to a level $49 billion below the President's request. And he said that this would mean, and I quote, "a very different defense establishment than is envisaged by the President." And there were those who were saying that on the Senate floor during the debates of Gramm-Rudman-Hollings, and others who were saying that such a view was nonsense, and yet it is coming to pass. And similar reductions will occur in your Department, sir, I think, but we will see.

EMBASSY SECURITY PROGRAM

Even so, I would like to state very strongly that your Embassy Security Program is a responsibility of this Congress, not just an option, in my view. You know, we send men and women around the world who put their lives in as much or greater jeopardy than our military people do. They are out there alone, they are unarmed, and they are faced with risks that I think you have to experience to imagine.

Under Secretary Spiers could testify to the experience at the Islamabad Embassy in November 1979 when a mob surrounded that Embassy, set it on fire; some 100-odd Americans got to the top floor, and the space was just about becoming intolerable, the floor was heating, was about to collapse, and at the very last moment some Pakistan helicopters arrived.

But Ambassador, how many hours had those people to live if they had not been rescued?

Under Secretary **Spiers**. I think it was 5 or 6 hours; most of the afternoon.

Senator **Moynihan**. And how many hours did they have before it was going to be too late—it was minutes, wasn't it?

Under Secretary **Spiers**. Well, that is a guess, but I think it was a very short time.

Senator **Moynihan**. Yes; it was a matter of minutes before you had a horror. And it is a horror that is going to be repeated if we do not do something about it, and I just want you to know that this Senator is with you completely.

Secretary **Shultz**. Thank you very much, Senator Moynihan. I appreciate that, and I know I express the thanks of all of my colleagues who serve abroad in expressing gratitude and admiration for that point of view.

Senator **Moynihan**. I mean, the number of our people who have been allowed to write a letter to their wife and then stood up against a wall and executed; the number of our people who have almost been burned alive; the number of our people who have disappeared. If we are going to send them out there, by God we have a right and a responsibility to protect them, even if it involves revenue increase of some sort.

Can I ask you another question about international organizations—and I note my colleague and friend, Mrs. Kassebaum, is here.

CUTTING CONTRIBUTIONS TO U.N.

One of the striking things in this budget is your proposal on international organizations goes from $336 million to $226 million in 3 years. It is a one-third reduction in our payments to international organizations, which is quite an extraordinary thing. And part of it is the $78 million outlays and authority which you are not going to provide the United Nations and its affiliated agencies in 1987, in pursuance of a measure we adopted that says you have got to get a weighted voting with respect to budgetary amendments.

Now, sir, this is 6, or 7, or 8 months off. Could I ask you, one, do you think it was a wise thing—I would imagine you would once you say you would like to see more influence in the budget, but if we cannot get it, do you think we ought to cut our contributions to the International Atomic Energy Agency and places like that?

There is a case for lowering the budgets of some of these agencies, but I am not sure it is a case for lowering our influence on that budget, which is what we will now do. That is also a statement that you have declined in importance in the world, because your contribution reflects your proportion to world GNP or whatever.

Could I ask you, what do you think of the arrangement we have given you; if we stretched it out, would it be better? And if it does not work out, what would be the consequences?

Secretary SHULTZ. I do not think we can realistically expect that the United Nations will formally revise its constitution and change the voting rights on budget matters. So it calls for something that I do not think is in the cards.

However, it and other efforts that we have made have really drawn to the attention of the United Nations administrative bodies our concern about the budgetary increases and about the general management practices in the United Nations. So it has been a very useful tool, and we have not minded using it, because we think that these messages are right messages to give.

Actually, the budget that the United Nations is putting up for next year has been tightened down a lot, and it is important for us to maintain our influence on that process. We hope there may be some advisory committee process that gives a special role to the countries that put up the most money, not as a formal matter but as an informal matter, so that we may have increased influence in paying attention to these budget things.

If that does come to pass, then I would hope that the restrictions that are put on by the law could be lifted, and we would not be under this constraint.

UNITED STATES IN DEFAULT

Senator MOYNIHAN. But we do face the prospect that in the next General Assembly, we will be in effect in default.

Secretary SHULTZ. We do. We would like not to be in that position. Of course, in the President's budget, we could not put up amounts that were a violation of the law that you have given us. We have to put up amounts that are in accordance with the law, even if we do not agree with it.

Senator MOYNIHAN. Have no fear, Mr. Secretary. There are 11 votes on your side.

Secretary SHULTZ. Well, I think there is a general concern which this administration has shared from the outset with the budgets of international organizations, and it has been pounded on, and I think with good effect. Now we are getting somewhere. And if we feel that we do, we would like to have the constraint imposed by the Kassebaum amendment looked at again by you, if it succeeds.

Senator MOYNIHAN. Thank you.

Chairman DOMENICI. Thank you, Senator Moynihan.

Senator Gorton, you are next, but could I just make one observation first?

LARGE DEFENSE CUT POSSIBLE

Mr. Secretary, Senator Moynihan has indicated under Gramm-Rudman-Hollings there would be a $49 billion reduction in defense, according to the head of the Congressional Budget Office, Dr. Penner. As a consequence, he concludes that Gramm-Rudman-Hollings, as I understand his argument, is going to cause a substantial automatic and dramatic cut in defense. Let me just suggest that I hope everybody understands that is a situation which would occur only if leadership in the Congress and the President are unable to put a budget together that establishes their own priorities. For anyone who thinks this is an awful austere target that they set in Gramm-Rudman-Hollings, I would like to repeat—I do not know that I have said it here, but I have said it many times across this country—the $144 billion deficit that it envisions is the fourth-largest deficit in the history of the Republic. It would appear to me in the fourth year of a recovery, we ought to be able to achieve the fourth-largest deficit in history. So I do not believe the results have to be draconian. Now, we may make them that way if we all get stuck in the mud and nobody gives, and that applies to everyone. But otherwise, it would appear to me our country could be very well-served in defending itself and taking care of other things, with a $144 billion deficit.

Senator Gorton?

Secretary SHULTZ. Thank you, Mr. Chairman.

I agree with those comments, and I also cannot help but reflect that we are talking about a budget of $1 trillion, more or less, and that is a pretty tidy sum, and somehow or other, we ought to be able to figure out how to do our business within that framework, I think.

Chairman DOMENICI. Senator Gorton?

WHAT FOR THE BUCK IN EL SALVADOR

Senator GORTON. Mr. Secretary, in your eloquent informal remarks in response to the two opening statements, before you began to read your statement, you mentioned the very close connection between the monetary resources you have and the attainment of certain foreign policy goals, and strongly, I think, correctly emphasized that connection.

Now, I would like to get your views on the extent to which our goals in El Salvador have been attained during the course of the past year, and as precise a prediction as you can give as to how well they will be attained in the next year, assuming that your budget recommendations are adopted, not from the point of view of military success in fighting that insurgency, but most particularly, in your goals of seeing to it or of helping the Government of El Salvador strengthen its democratic institutions, end arbitrary arrests and killings, and most particularly, proceed with its land reform. Can you reflect what we have gotten for our money in the last year and what you expect us to get for it in the next?

Secretary SHULTZ. I would like to reflect briefly and then ask Mr. McPherson, following the invitation of the chairman, to reflect a little further.

I think the U.S. assistance in El Salvador and in Central America generally has been very productive for us. We have seen this resurgence of democracy. We have seen the emergence of a greater respect for the rule of law throughout the region except for Nicaragua. We have seen the stability that goes with that.

I think it is important to say that security assistance is an essential ingredient to it. These are not antithetical. If you cannot maintain security in your country, you cannot really get around to doing other things very well.

So these are not alternatives; they are things that have to be done together.

In terms of the last year, of course we have seen a successful election, and we have seen the beginnings of progress on economic matters, although they have a long way to go. President Duarte has recently put in a so-called "austerity program" that is very tough to sell anywhere—just as it is tough to sell around here—and he is having his difficulties with it, but he is on the right track.

Peter, would you comment a little more?

Mr. McPHERSON. Yes, Senator; I spent a couple of days in El Salvador last week, as a matter of fact. As to the land reform first, it seems to us that the land reform has been a very important instrument in terms of dealing with the broader political problem in the country; it has been very important. On the other hand, economically, it has a good deal to go. The legislation which was passed recently by Congress, the authorization legislation allowing us to use some money for compensation, you have been interested in, that we are proceeding with, I think will help firm up some title and have a politically stabilizing impact.

On the other hand, there are a number of reforms that I think are key. Those cooperatives need to truly be cooperatives, not government-owned entities. We need to be able to have people transfer property to their beneficiaries much sooner than they currently can under the law.

President Duarte—I spent 3 hours with him, as a matter of fact—and I talked about this a couple of different times. It is my hope that in this next year, a number of these issues that are fundamental to making land reform an economic success would be grappled with.

Senator GORTON. Thank you.

PHILLIPINE ECONOMIC ASSISTANCE LEVEL

Mr. Secretary, on another subject, would you reflect for us today on the money which is contained in this budget for the Philippine republic and whether or not you would consider it appropriate to leave that figure unchanged in light of the fact that the present regime almost certainly has stolen the election of a week or so ago and cannot really be considered to be a legitimate democratic regime?

Secretary SHULTZ. Senator, I think that we should not be doing anything about our aid levels right at the moment. For one thing, we have Ambassador Habib out there, one of our most skillful people in the country at going someplace and getting a feel and giving us a very factual and objective report, and we want to hear what he has to say, which probably will be next week sometime, when he gets through with his current mission.

I think we have to watch unfolding events in the Philippines, and we have to keep in our minds that it is very important for us that we are going to be a part of the future of the Philippines, and very important for the Philippines that they are associated with us.

And our flows of assistance direct themselves to economic reform, which is badly needed, direct themselves to professionalism in the military and greater capability in the military, which is badly needed. And in general, our support goes for an open political process, which we saw on exhibit in much of the electoral process, but as the President has said, in the end it is clear that the election was badly affected by fraud and violence, mostly by the party in power, and so one cannot say that we got out of the election what one wants to get out of an election, namely, a legitimized and credible government.

But we need to watch these unfolding events and be careful how we handle things so that we do as much as possible to be a part of the solution, and as constructive a part as possible.

I might also point out that our flows of assistance to the Philippines, in part of course, associated with base rights, are not as large as, say, the Japanese flows and it is also true that World Bank potential flows and IMF potential flows are also quite large. So that we are part of a picture, and what we do in order to be effective, we need to be consulting with others and trying to put together a picture that is comprehensive and has an overall strategy coordinated in it.

Senator GORTON. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator Gorton.

Senator Sasser?

Senator SASSER. Thank you, Mr. Chairman.

LEGISLATION TO RECIND AID TO PHILLIPINES

Mr. Secretary, I would like to follow if I may, on a question that Senator Gorton just raised on the issue of the Philippines.

I think we all agree that the preservation of democracy in the Philippines must be a primary goal of American foreign policy. It has been for a long time. And there is general agreement as to how vital our military bases are in the Philippines. Both the Subic Bay Naval Base and Clark Air Base are the largest military installations outside of the continental United States, and Subic is our oldest base outside of the continental United States.

Now, it appears to me that the longer President Marcos stays in power, the stronger the National People's Army becomes. It is growing now, according to reports that have appeared in the popular press, by almost a geometric ratio. This insurgency in the Philippines is indigenous to the Filipino people. There is no evidence, I am advised, of any material outside support at all of this insurgency.

So it appears to me that our vital interests, which are to protect our bases in that region of the world, are not served by a continuation of either economic or military aid which would be funneled through the Marcos government. The longer President Marcos stays in power, the worse it is for the United States and U.S. interests in that region of the world.

Now, yesterday, I introduced legislation to rescind the remaining foreign aid funds for fiscal year 1986 for both foreign aid, economic and military, and military construction in the Philippines, feeling that denying such economic benefits to the Marcos government is an appropriate form of pressure for our Government to exercise. It sends a signal not only to President Marcos, but I think also a signal to those who want true democratic reform in the Philippines that the United States is not willing to continue to subsidize some of the efforts of the Marcos government or for us to allow our economic or military aid to be subverted in such a way that it is, in essence, a subsidy of President Marcos' activities and those of his government.

I was interested to see today that the major opposition candidate, Ms. Aquino, said that our aid to the Philippines should be stopped or at the very least, should not be funneled through the Marcos government.

I fear, Mr. Secretary, that we need to send the Marcos government a strong, clear, immediate signal. I think only the administration can do that. I fear that if we do not pull the plug on President Marcos, that in due course, the Filipino people are going to pull the plug on the United States and on our bases in that region of the world.

My question is this, Mr. Secretary. Are there any plans being immediately contemplated by the administration to terminate or suspend economic aid to the Philippines?

STATE DEPARTMENT PEOPLE TALKING TO ALL CONCERNED

Secretary SHULTZ. Right now, as I said, we have in addition to our Embassy and our very fine Ambassador, Steve Bosworth, who has been doing a great job, perhaps our most experienced diplomat. He is there; he is talking with all parties. He is talking with Ms. Aquino, with her party people, with President Marcos, with labor people, with business people, with Cardinal Sin, with the church hierarchy. He is getting around very carefully, and we are in the process of assessing the situation.

I think we have to remember that this is essentially first a Filipino problem, and we want to see how the Philippines are going to handle it themselves. But you are right—we have a big stake there. We have a stake in freedom. We have a stake in democracy. Let us put that first, over and above the bases. The bases are important. They are important to the Philippines and to other countries out there in addition to ourselves.

So we feel that we have on our hands a very difficult and delicate situation, and we do not want to jump at it with some precipitous action here.

It is clear that fraud and violence on a systematic and widespread scale in an election such as we have seen only provides fuel for the insurgency. So that is a problem. It is also clear that what we need to be supporting is a valid political process, a more open entrepreneurial, market-oriented economic process, and a professional military that can contend adequately with the insurgency, and with less for the insurgency to go on because of the other reforms that are undertaken. Those are our objectives.

We want to stay connected with the Philippines. We do not want to walk away from them. And how to do that under present circumstances is a difficult task, and I would counsel care and at least a little patience.

We have sent them a very strong signal. Your comments today are a signal, as mine are. Most importantly, the President's, last Saturday, reverberated strongly. So they know our concern. And now, I think we want to work with all parties and see how we can help resolve these problems in the most effective and successful way.

Senator **SASSER**. Mr. Secretary, I realize that this is a delicate situation at the present time. I would just say this, that this problem is not something that has blown up overnight. It has been a long time coming. The seeds go back even before this administration came to office, as you know.

But I fear now it has reached a critical mass, and we are at a point where we have got to go one way or the other I suspect, very rapidly. So I would urge the administration to move with all deliberate speed in trying to send the most clear and unambiguous signal possible.

MARCOS TO PLAY "SOVIET CARD"

And if I could impose, Mr. Chairman, to ask the Secretary one more quick question, Mr. Secretary, President Marcos has been making a number of threats lately, one of which is to play his so-called Soviet card. He sent his wife to Moscow a few months ago, as you know, and it appears that this so-called professional anti-Communist, Mr. Marcos, might be preparing to invite the Soviets in if the United States brings pressure on his government. At least, he appears to be trying to leave that impression.

How serious do you think this threat is that Marcos will try to play a so-called Soviet card?

Secretary **SHULTZ**. Well, I do not think that that will work. Certainly, it is not going to cause us suddenly to call something legitimate that is fraudulent. We will have to say what the truth is.

It is interesting that one of the few official government publications that seems to be content with the declared result of that election is TASS, which has come on strong in favor of President Marcos.

Senator **SASSER**. Yes.

Secretary **SHULTZ**. But anyway, from our standpoint, we have to be very much in favor of democracy and freedom, and we will stick to our principles.

But as I say, we need to do it with care. We need to remember that with all that has been said, President Marcos has great support in the Philippines. We want to be, as I said, a part of the future. We are going to handle ourselves with care in order to have that take place.

I would welcome, as our own thinking evolves here over the next week, an opportunity to be in close consultation with members of the Congress who are especially interested in the subject, and I know some have a deep interest in this subject, and to consult carefully so that we act on this matter of great importance to us on a unified and thoughtful basis.

So that is the way I will try to organize things, and when Ambassador Habib is here, I am sure you will want to hear from him as much as we do.

Senator **Sasser**. Well, thank you, Mr. Secretary, and I look forward to consulting with you or your associates on this very critical problem.

Thank you, Mr. Chairman.

Chairman **Domenici**. Thank you very much, Senator Sasser.

Senator Johnston.

BUY MORE OIL FROM MEXICO

Senator **Johnston**. Mr. Secretary, on the question of purchases of oil from Mexico, I just want to point out to you that the projections of the Energy Information Agency are that present imports of 5.4 million barrels a day are predicted to rise to 11.7 million barrels a day by 1995. There is a new, updated Energy Information Agency forecast coming out, confirming that further; just in the next week or two it will be confirming that.

It seems to me it makes a lot of sense, rather than giving other aid to Mexicans, to purchase the oil which gets the dollars to them and gives us something for that.

WHAT DO WE GET FOR AID TO EGYPT

Mr. Secretary, since 1970, we have given Egypt some $13 billion. Now, I happened to have been one of those on the Foreign Operations Subcommittee who helped fend off some cuts in that program last year, among other reasons because I thought the timing would have been very, very bad last year to have cut that program, in view of what events transpired at that time.

But it seems to me at this time that we have no new initiative going in the Middle East of which we are asking the Egyptians to be a part, and I do not argue the point; I really ask the point for information: What do we get for these huge allocations to Egypt?

Secretary **Shultz**. Well, first of all, I think we are helping the development of Egypt's economy, and we are helping them in their own ability to provide security for themselves and stability in their neighborhood.

Senator **Johnston**. Well, if I may interrupt, let me ask this. If we did—what I am not recommending here—but if we pull the plug completely on aid to Egypt, is there any thought that they would again be a confrontation state with Israel, or do you consider that peace treaty between the two to be indissoluble?

Secretary **Shultz**. Egypt has stuck with its peace treaty. With all of the ups and downs of its relationship with Egypt, nevertheless, the peace treaty has remained as a bedrock, and in the face of numerous urgings and invitations and pressure and so forth to walk away from it, President Mubarek has declined to do so. So they have stuck with that.

We have also seen in the last year a considerable amount of effort between Israel and Egypt to warm up that chilly relationship. I cannot say that it has all gone exactly as we would hope it might, but I think the prospects are there that it may. As I said earlier, in terms of the peace process, naturally we want to see more. We want to see additional neighbors of Israel sit down with Israel and work out the terms for peace. But at the same time, we do have Egypt as the biggest neighboring state having done that, and so we want to keep that in place.

PURCHASING PEACE FROM EGYPT

Senator JOHNSTON. Well, are we purchasing that peace from Egypt? In other words, are we keeping Egypt a nonconfrontational State by this aid; is that part of the reason for the aid?

Secretary SHULTZ. Well, I would not like to put it in terms of purchasing it, quite that way. I think that Egypt has seen, and President Sadat and his vision, followed by President Mubarek, has seen that in the region, greater peace and stability will help everybody and help Egypt. And we are helping to bring that about by our assistance, not only to Egypt but to Israel.

Senator JOHNSTON. Well, now, the economic reform in Egypt has been not forthcoming at all. I notice in your opening statement, you talked about the reform in India and what great strides they have made. They have not done that in Egypt, and they have not accepted our advice on economic reform.

So I just wonder what we are getting. We do not get reform. We are not getting them to join in any initiative. That is a huge amount of money, isn't it?

Secretary SHULTZ. I do not believe it is correct to say there has not been any reform. There has been. And in my statement, I mention some of the elements—in electricity prices, gasoline prices, and the prices of foodstuffs. And of course, a basic reform is to get the prices up to a market level so that your supply and demand factors can operate.

So they have made some important moves. We do not believe they have made moves anywhere near enough, but they have moved in the right direction. And we are trying with our assistance to help them just as we helped Israel, to face up to their problems and do something about them.

So the picture has some good things in it, and it also has some problems, too.

Senator JOHNSTON. To quote your statement, you say, "These incremental actions, however, still fall far short of the comprehensive effort needed for long-term economic viability."

Secretary SHULTZ. That is right.

Senator JOHNSTON. It just seems like after $13 billion, we ought to be beginning to not be falling far short, but making great strides in that right direction.

Secretary SHULTZ. We would like to see further strides, and we urge and work with them to bring it about. On their side of the issue—and usually I argue the other side—but on their side of the issue, major sudden increases in food and energy costs to a large and poor population have political costs associated with them and it has to be managed in a careful way and eased into.

So we recognize that that is part of the problem.

Senator **Johnston**. Mr. Chairman, if I may just comment on one more thing here——

Chairman **Domenici**. Yes; go ahead.

LARGE INCREASE IN STATE PERSONNEL

Senator **Johnston**. State Department personnel has increased since 1980 by 197 percent, and this year you have another 849 full-time employees.

It looks to me as though that is excessive in a day of Gramm-Rudman. I note, for example, that nine of these are scheduled for the FSM and Marshall Islands, which contain a total of only 70,000 people. It looks to me like somebody is trying to get some halfway house to retirement out there in what used to be the Trust Territory of the Pacific Islands.

Just last year, I had to put some language in one of our bills to keep them from spending I think it was $9 million, where they were going to build a New Orleans-style home out in Majuro. I appreciated the compliment to New Orleans architects, but $9 million for a home—and the State Department is not even overseeing the economic activity out in the Trust Territories. That is done by Interior.

We have gotten along for 40 years without State Department people out there, and here with Gramm-Rudman coming along, we have got to send another nine people to service 70,000 people.

If that word gets around to the farmers, whose programs are being slashed, it is not going to sit very well. So I would say we need to scrub that request for personnel rather severely.

Secretary **Shultz**. Well, Senator, I believe—I do not have all the figures here, but maybe Ambassador Spiers does—that the bulk of the increases are attributable to security concerns, and we have been beefing that up very strongly.

Senator **Johnston**. I think 117 of these are for security purposes; 849 full-time positions and 117 are for security.

Secretary **Shultz**. You are talking about this year.

Senator **Johnston**. This year.

Secretary **Shultz**. Well, we can go through that in detail with you. One thing that we have been doing in recent years and which I have been strongly supporting is the rebuilding of the State Department reporting and analysis personnel and function. That is what we are all about. And essentially what has happened is that the burden of administration and the burden of security have tended to contract against that and work against our function

Now, bear in mind that something like 70 percent of the people who are serving in our embassies abroad are not attached to the State Department; they are other agencies—DOD and various other agencies—so that we have a large administrative burden on behalf of others.

But we will be glad to go through these in detail.

As far as the Trust Territories, or former Trust Territories, are concerned, they are now independent countries. So I think that the representation there should not be as though they are part of the Interior of the United States. They are independent countries, and we need to look carefully at the Pacific.

And once again, I think—this is an area that I have been worrying about and paying attention to, because all those little islands—and I was out there in World War II and fought over some of them—they are very important strategic locations. For example, now we are workng very hard trying to work out a fishing agreement with them so that we avoid additional, among other things, Soviet encroachments, as in Kursbash last year. And we need to be paying attention to those islands. Just because the are small does not mean they are not important.

Senator JOHNSTON. Well, I certainly agree with their importance. But I mean, we do not pull the Interior people out. We have got the Navy people in there, handling the capital improvements program, and we are just putting people in there, and New Oreleans-style architecture—well, I hope you keep the New Orleans-style architecture.

Secretary SHULTZ. Well, we will have New Orleans-style, but we ought to be able to do it with a little less money, and we will certainly work on that.

Senator JOHNSTON. Thank you, Mr. Secretary.

Chairman DOMENICI. Thank you, Senator.

Mr. Secretary, let me first—I think I am going to wrap things up; in about 10 minutes, we will be out of here, I hope. I have asked the Senators if they have any additional questions, and I understand they do not.

HOW TO HELP NEW DEMOCRACIES

Mr. Secretary, I am of late very, very concerned about how we are collectively able to help new democracies that we encourage to come onto the international scene. I do not think there is a more important role for the United States as a people than to encourage new democracies to come on the scene. I am absolutely convinced that while we have many roles in the world, encouraging democracy is one that I consider to be vital. Of late, I have become convinced that democracy is one of the benefits and burdens of our magnificient Constitution. I think it was inevitable that as our Constitution worked, and we became what we are, that this Nation was going to have burdens in the world to help others have a little shot at freedom.

Let me recount an incident that actually happened, and I will get to a more serious question in a moment. Two years ago, I was part of the Kissinger Commission on Central America, and I enjoyed the experience because I can speak a little Spanish. Since then I try to keep up with my friends in Guatemala, Honduras, and El Salvador. I continue to have a strong interest in Central America, although I am not on the right committees around here to help as much as I would like.

Last year, six weeks before the election in Guatemala, their Secretary of State Mr. Andrade, the counterpart to you though that is not his title, was busy trying to find—if you can imagine—a couple of big generators for an electric system that we probably have in salvage yards all over this country as part of surplus that the military can sell. The total cost was less then $10 million.

Do you know why he needed them? The lights in Guatemala's capital city were going out part of the time because they were waiting for a dam to be completed with additional hydroelectric capacity. They are promoting democracy and trying to say, "Let us go vote," and "Hurrah, we are going to have another little shot of freedom," and the power would go out because they could not find a couple of generators to keep the electricity flowing for their elections.

Would you believe that we did not have the flexibility in our foreign assistance program to help them? The foreign minister came over here to see us, and Congress had no pending bill going through to put a little rider on. And thank God, after an awful lot of discussion, I think, between you and the Defense Department, we found a couple of surplus generators.

Secretary SHULTZ. That is correct, and we finally were able to provide that power.

EARMARKING OF ASSISTANCE FUNDS NEGATIVE

Chairman DOMENICI. Now, this statement on my part is not by way of criticism at all of you and the administration. It is by way of concern. If we are going to have to hold the foreign assistance budget tight—and I believe we are—you are going to be fortunate if there is a freeze rather than a 12-percent increase for international programs. I am suggesting that we cannot keep the current pattern of aid, including some aid that appears to be quasi-entitlement. We must work together to find ways to give you the flexibility to help Guatemala, Honduras, and El Salvador, as they seek to aspire to become mature democracies.

It is tough for politicians in those nations, when there is overwhelming poverty, to advise them to feed their people with democracy. They need jobs and hope, too. I for one encourage you to insist that we have some additional flexibility vested in you—I am not speaking of military aid at this point; I support most of that, and I support the Nicaraguan effort, and I will talk about it in a moment. But while we are worried abut Nicaragua and what they are going to do in this hemisphere, I believe we ought to have every means available to do the reasonable things for the budding democracies. I will put dollars where my mouth is on that, but I do not believe we can get that done if we have 60, 70, or 80 percent of the foreign assistance budget already earmarked. By doing that, we have put this hemisphere in some kind of secondary position to other regions of the world. I frankly think it is our No. 1 priority at this point, and I just want to give you my expression of concern.

The Senate has not been briefed at length, and hopefully there will be more detail later, on Nicaragua and what is happening to their people. You know of my support for that effort on our part as a Nation and the President's proposal, but if we cannot help those Central Americans who are developing when they need it—Guatemala needs $100 million, I believe, for some very critical economic adjustment to prove to their people that they were correct to choose democracy. I just believe a great Nation like ours has to be in a position to trust somebody like President Cerezo. We need some kind of a fund, even if it has a cap on it, for new democracies that are willing to tackle their inherited economic problems, or we are not going to make it because these new Latin American democracies are not going to make it.

SOLVENT COUNTRIES NEED TO HELP NEW DEMOCRACIES

Now, having said that, let me ask, are there other countries that are our friends that are solvent, such as Japan, that consider helping the budding democracies in a concerted way with us, and if so, what are they doing?

Secretary **Shultz**. We have with Japan and some other countries a systematic effort to have sessions talking about what is going on in various parts of the world, and what our joint interests may be, and to the extent we can coordinate the flows of our assistance. Japan, particularly since it has a very low defense budget, we have felt should step up strongly to assistance of various kinds, and we have urged that on them. And they have had regular increases in their assistance budgets, and they have directed that assistance to some extent in the light of the discussions that we have had with them.

They have put money into Central America and the Caribbean. We have suggested that they ought to consider it, and they have been considering it.

So I think the thrust of your point, that we should be coordinating with other countries who are like minded with us is correct, and we are trying to do that.

Chairman **Domenici**. Mr. Secretary, I wonder if it would be asking too much if you and your people could supply a few more details that would fill in some actual initiatives and substance into that last generalized statement; could we do that for the record?

Secretary **Shultz**. Yes, sir; we will do that.

Chairman **Domenici**. I would appreciate it. I for one, when talk turns to Japan and the balance of trade problem, will start reminding them that I think maybe they ought to show a little more concern about Central America. Japan does not pay anything for defense to speak of, and I understand their constitutional prohibition, but maybe they could provide a little more assistance to some of these regions where we are burdened. Japan is free today because of our aid after the Second World War.

Secretary **Shultz**. We will provide you with material. I think what you will find is that Japan has been stepping up to the mark in this respect. But we will give you chapter and verse.

Chairman **Domenici**. I appreciate that.

[The following was subsequently supplied for the record by the State Department:]

AID TO NEW DEMOCRACIES

The United States and Japan consult regularly on both Latin America and assistance levels. Under Secretary Armacost will lead U.S. discussions with Japan in an annual review of foreign policy and foreign aid concerns in March.

Japanese assistance to Latin America has increased substantially in recent years. The attached chart gives Japanese ODA (Official Development Assistance) levels for several countries in 1984. Information for 1985 is not yet available.

In addition to increasing development assistance, we have encouraged Japan to become involved in the Caribbean Basin Initiative (CBI). Japan participated in the November 1985 annual CBI meeting in Miami, and a joint Japanese government/private sector mission is currently visiting several Caribbean and Central American nations to explore investment possibilities.

1984 JAPANESE ASSISTANCE TO LATIN AMERICA
(millions of U.S. dollars)
(actual disbursements)

Country	Grant Aid	Technical Cooperation	ODA Loan	Total
Argentina	3.23	3.88	1.56	8.67
Bahamas	0.00	0.01	0.00	0.01
Barbados	0.00	0.08	0.00	0.08
Belize	0.00	0.04	0.00	0.04
Bolivia	9.80	5.56	14.27	29.62
Brazil	0.00	15.75	19.85	35.59
Chile	0.19	3.38	-1.90	1.67
Colombia	2.88	3.39	18.36	24.62
Costa Rica	0.00	1.13	-0.24	0.89
Cuba	0.00	0.12	0.00	0.12
Dominica	0.00	0.08	0.00	0.08
Dominican Republic	0.17	2.11	3.73	6.02
Ecuador	0.73	0.80	0.46	1.99
El Salvador	0.00	0.12	-0.92	-0.81
Grenada	0.00	0.03	0.00	0.03
Guyana	2.00	0.16	0.00	2.17
Guatemala	0.00	1.47	0.00	1.47
Haiti	1.31	0.11	0.00	1.42
Honduras	3.64	3.79	6.30	13.73
Jamaica	0.00	0.66	13.44	14.10
Mexico	1.57	6.68	22.37	30.62
Nicaragua	0.00	0.05	0.00	0.05
Panama	0.15	4.70	0.00	4.85
Paraguay	1.05	12.99	8.98	23.01
Peru	2.43	12.34	10.08	24.85
Suriname	0.00	0.02	-0.08	-0.06
Trinidad	0.00	0.02	0.00	0.02
Uruguay	0.00	1.74	0.09	1.83
Venezuela	0.00	1.06	-0.15	0.91

Other OECD countries play significant roles in assistance to the region, particularly the Caribbean Basin. Canada has announced the intention of doubling its bilateral aid to the Commonwealth Caribbean by 1987. Prime Minister Mulroney has also announced plans for a preferential trade arrangement similar to the CBI for the Commonwealth Caribbean. Canadian aid flows to Central America have also increased.

The European Communities have several programs, the most important being the Lome Convention which provides trade preferences for imports from the Commonwealth Caribbean. It also provides for economic assistance, investment incentives and technical cooperation. In November the EC adopted a framework agreement with the Central American countries which includes an agreement to double EC assistance to the region over the next five years.

Unilaterally, the FRG has increased assistance to the region, as has France, with a particular focus on the Eastern Caribbean. Within the region itself, we should not forget that Venezuela and Mexico, through their oil facility, have continued to provide significant assistance to Latin American countries despite their own economic difficulties and debt service problems.

Chairman **Domenici**. My last comment. Obviously this is not a line item committee and not an appropriating commitee but, we are going to have to set a target in Function 150 for both budget authority and outlays.

SUBCOMMITTEES BOUND BY BUDGET AUTHORITY AND OUTLAYS

I would remind your people who are here today with you, who follow this budget process, that there is one very major change in the law this year, aside and apart from the targets that we are discussing, that are mandatory. This year, for the first time, subcommittees of the Appropriations Committee in the U.S. Senate will be bound by both budget authority and outlays, Secretary Schneider.

After we have a Budget Resolution, when we allocate the composite outlays, they will split that up among subcommittees. The Appropriations Committee will not have any more than the total we give them—not "we", but the Congress, gives them—they will not have any more than the total budget authority. But a point of order will lie on both counts per bill. Budget authority and outlays will be binding.

That change, on the one hand, is restrictive. On the other hand, many around here saw it as something absolutely necessary. So we will do our best, but ultimately, the issues that the Secretary is talking about—earmarking; entitlements; if we are tight, where should the money go—are not going to be decided by us. And what we are going to decide here is, within the total budget, how much can we put in any one function and still get to that $144 billion maximum deficit amount and handle foreign problems, domestic problems, defense, and taxes. That is basically our challenge.

Two last remarks; one to you, Mr. Secretary, and then one to Mr. McPherson.

NEED FOR TAX INCREASE

First, I believe you are a significant part of the President's team, and tremendously influential. I personally think that you are doing a marvelous job. I would urge that since you are sought out by the President not only in this arena about which you are testifying here, but as part of his economic team, that you consider the problem that we face here.

If we are to get to the $144 billion deficit reduction mark and not use the Gramm-Rudman-Hollings trigger, but use our good common sense, we probably have to find a minimum reduction, if there is any substantial defense increase, of $40 to $45 billion in outlays from current policy.

I think you understand now, having gone through this first sequester exercise, that that amount of outlays, as a rough rule-of-thumb, is double in budget authority problems. To put the dimension of the problem into our discussion, it is about $80 billion in program cuts.

I have concluded that there will have to be a dramatic cut in the President's proposed defense increase, dramatic reductions in domestic programs, if there is no revenue to glue a package together or the trigger will be exercised in August and September, and it is no one's choice.

I urge you, Mr. Secretary, because of your broad influence and understanding, to note that some of us who consider ourselves to be responsible, want defense to get its share, and foreign assistance to get its share, that we do not think we can get a budget through the House and the Senate that does not have something to glue it together called a revenue increase, and it does not have to be an awful lot.

When that is discussed, I hope the fact that you know economics, that you have participated in economic thinking for most of your life, will help you truly understand our proposal from the practical sense of achieving political consensus in a difficult time. I am confident that you will not believe as some have, that this kind of package will cause economic chaos. To some, an oil import fee as part of tax reform, or tax reform which shifts around anywhere from $110 to $140 billion in tax burdens from one group of taxpayers to another, is all apple pie, and that tax shift will help the economy.

I am sorry to have you as a captive witness, but I believe strongly that we must get the job done on the budget, and avoid the Gramm-Rudman-Hollings sequester.

You do not even have to respond; I do not ask you to. I tried my best to tell you how I see it.

ENERGY AND MINERAL EVALUATION IN CENTRAL AMERICA

Let me say to Peter McPherson, we do appreciate the efforts you and AID are making in Central America with reference to energy and mineral evaluation for those countries. I think you have put together a very exciting little program with American experts, headed by some scientists from Los Alamos, with people from there who speak the language. I am convinced it is going to pay dividends to us and to the Central Americans as we show them how they might become less dependent upon outside energy and use more of their indigenous supplies.

It is a very small issue, and it has nothing to do with this budget. It is an appropriated item. But I thank you, and I think it has been a very excellent approach.

Mr. **McPherson**. Thank you, Mr. Chairman.

Chairman **Domenici**. Senator Lautenberg, I understand that you do have some questions. I thought we were finished, but I would be pleased to yield.

Senator **Lautenberg**. I take the hint, Mr. Chairman. Yes, I do have some questions.

Chairman **Domenici**. Please proceed.

Senator **Lautenberg**. Mr. Secretary, I am pleased to see you. I am sorry I was not able to stay through all of the questions and answers because I would like not to be redundant. If you have answered something, please do not hesitate to say that it is in the record, and we will take a look at that.

FOREIGN AID FAST GROWING PROGRAM

Despite the push to cut the deficit, the Administration proposes a budget which makes foreign aid one of the fastest growing nondefense programs, and no one really argues, for instance, with the most important section in terms of expense buildup, and that is the part that goes to protect Americans around the world.

The budget, however, does contain some questionable requests, which I understand have been discussed by some of my colleagues around the table, for Guatemala, the Philippines, and Turkey. And this budget number is bound also to increase when the President sends his reouest for military aid to the Contras.

The international affairs budget has got to be subject, as you know from your own experience, especially as OMB Director, to the same kind of discipline that other parts of the budget are undergoing.

Conversely, I guess we can say we have to examine programs based on their importance, their priorities, not simply numbers without consideration for their value in our planning, both domestic and foreign. And that is one of the things that distresses me so about the automatic approach that Gramm-Rudman takes, because there, we are no longer evaluating the priorities. Presumably, they were evaluated when the budget request went in initially. We have priorities in the domestic programs, priorities that are important, as are our State Department activities.

TERRORISM

And I would like for these few moments that we have here together to not deal so specifically with the numbers. They have been reviewed fairly thoroughly. I support some of the initiatives that you have proposed, but not all, as you would expect. The effort to beef up our Embassy security around the world is critical, I think.

I was one of the last of the elected officials to be in Beirut before we moved out, and I was there right after the Embassy was blown up. I saw the damage done, and it was devastating. And I think we learned from that experience that we could have constructed something different that might have provided more protection. I am not second-guessing, but suggesting we learn from the events. And we cannot skimp on protecting the lives of diplomats or government personnel that are there. But we Americans are increasingly becoming targets of terrorism. Business travel and recreational travel have become for many a dangerous event. And I have talked to lots of people who are canceling trips to go abroad simply because they are afraid of being waylaid in an airport or while in flight or perhaps even on a ship now.

Mr. Secretary, I know that you advocate tough measures in response to terrorism, including military responses when appropriate, and we know that you believe that military action can work. It carries enormous risks politically and personally. And we have seen, unfortunately, that economic sanctions, which require the support and cooperation of friendly nations to succeed, often do not elicit that support, and that is distressing, because I think that would be a better way to do things.

But there has been increased emphasis on using the legal system to fight terrorism. And getting that system in gear to fight terrorists does not require substantial additional dollars. The administration took this approach when it sought an arrest warrant for Abbas. And you have not commented on this, I do not think, before, but how effective, Mr. Secretary, do you think the legal approach to terrorism can be? Can that work, do you think?

Secretary **SHULTZ**. I think we should regard it as one of the most important and essential tools which, along with other things, gives us the right strategy and approach to terrorism.

We should be building, to the extent we can, a rule of law here, and it needs to be one that interacts with other countries.

We had a law passed that makes it a criminal act in the United States to hijack and hold hostage American citizens. I think that is a good thing. I think we should have a similar law that makes murder of an American citizen abroad a violation of U.S. law.

Now, you may ask, what good does that do. Well, I think it can do a lot of good if it is combined with appropriate extradition treaties. And we have to recognize the importance of a web of extradition treaties in connection with the building of this rule of law.

And we have some work to do ourselves, and as you know, we have an extradition treaty with the United Kingdom before the Senate which we would like to see acted on. And the thing that needs to get changed about it is what amounts to a political exemption. We need to say terrorism is terrorism, and there is not any excuse for it, and take that point of view.

So at any rate, I think that developing a pattern, a rule of law, that does have international connections to it, is a very important aspect of this, and this is one of the subjects that our talented legal advisor, Judge Abe Sofaer, is working on, along with the Justice Department.

INDICTMENT OF YASSER ARAFAT

Senator **LAUTENBERG**. Well, in that connection the Justice Department is currently reviewing evidence and legal grounds for indicting Yasser Arafat for the murder of American Ambassador Cleo Noel and Charge D'Affaires Curtis Moore in Khartoum, in Sudan, back in 1973, and this may be the first real test of the administration's determination to make good on its pledge to apprehend, indict and arrest terrorists.

Has the State Department—I take it from your comment about Judge Sofaer—to your knowledge, had any input into the Justice Department investigation?

Secretary **SHULTZ**. It is a Justice Department investigation, and we want to provide help and information as best we can. I cannot give you chapter and verse on it, however.

Senator **LAUTENBERG**. But do you know whether it has been requested at this point, Mr Secretary?

Secretary **SHULTZ**. I just do not have the information in my mind.

Senator **LAUTENBERG**. If I could get a response after this, to know where the State Department sits so far on this, I would appreciate it.

Secretary **SHULTZ**. Would you like to have me ask Judge Sofaer to call you and give you that information, or do you want a statement for the record; how would you like it?

Senator **LAUTENBERG**. I would like a statement for the record.

Secretary **SHULTZ**. OK.

Senator LAUTENBERG. Thank you.

[The following was subsequently supplied for the record by the State Department:]

STATE DEPARTMENT COOPERATES CLOSELY WITH JUSTICE

This is primarily a Justice Department investigation. From the outset, the State Department has cooperated closely with Justice. As part of this effort, the State Department has undertaken a comprehensive review of its historical records in order to ascertain what information may be available. The Department intends to continue to provide whatever assistance and information will be required to complete this investigation.

ABDUCT SUSPECTED TERRORISTS

Senator LAUTENBERG. Mr. Secretary, the administration is reported to be considering proposals to abduct suspects in terrorist acts on Americans abroad and bring them before American courts. This report comes from a New York Times story a few weeks ago. Is that a practical approach?

Secretary SHULTZ. Probably not practical in many cases. If you have a situation that is relatively chaotic in some geographic area, perhaps you can do that, but when you are dealing with another well-organized country, presumably, your extradition treaties represent the route to go.

Senator LAUTENBERG. But we took action—which I think was applauded around our country—in the case of the Achille Lauro, in apprehending those criminals, and we felt like it was the right thing to do in a friendly nation and so forth.

So it would seem to me, at least based on that example, that (*a*) we showed that we mean business, and (*b*) that we showed that in those cases where there is a chance to do it, we are going to go ahead and do it.

Secretary SHULTZ. Absolutely. And in the case of the terrorist who held hostage our people in the Achille Lauro and murdered Mr. Klinghoffer, we request to be next in line to the Italians in having those people brought here and tried, and they are conducting their own trial, and after they are through, they will consider our request.

Senator LAUTENBERG. Mr. Secretary, I know you discussed Israel and Egypt at some length here, and I will not go over the same ground, I hope—I will be brief. One of your bulbs is out up there, Mr. Chairman.

Secretary SHULTZ. The red one is working. [Laughter.]

ISRAEL CONDUCTING SHARE OF DEFENSE OF FREE WORLD

Senator LAUTENBERG. Mr. Secretary, just because I am last does not mean I am least, and I know how the chairman keeps time around here.

I just wanted to draw a relative comparison. As I see the request—and I know, again, that you have been asked about Egypt and its response to Israel and its response to us, and the value of our aid—but the request for Egypt this year has dropped about 5 percent from the post-Gramm-Rudman result of 1986, about $100 million on a base of $2 billion. Israel, on the other hand, dropped

$600 million on a base of $3 billion. So we are talking about a 20-percent decrease.

I think it is awfully important to state what we get for our foreign aid in these days of competition among domestic needs, critical needs. We cannot go to the Farm Belt without hearing criticism about spending money on foreign affairs and so forth when the farmers are losing homes, and we see that view of foreign aid in some of the cities, too. I would like the record to be clear that the money we send to Israel ultimately is responsible for an easing of the burden that we have to bear in many cases to defend a critical area of the world.

Is it fair to say, Mr. Secretary, that we would be spending significant sums of money on our own if Israel was not conducting her share of the defense of the free world?

Secretary **Shultz**. Well, I think the funds that we are providing to Israel and Egypt are fully justified and that we get our money's worth from it as the United States. In addition, it does good in those countries and helps to ensure security and a measure of stability for that reason. There is a lot more to do, but some things are being done. And I am a strong supporter of what we are doing there.

I do not know exactly what figures you are looking at there, but I would caution against looking from year to year, because you remember, we did have a big supplemental for Israel and a lesser one for Egypt, designed for some very specific situations, and basically, I think that money has worked. It has been very helpful. And the Israeli economy in particular, they have done a great job. They have plenty of problems left, but they have done an awful lot. So I think that was money that has been well spent. But it was a one-shot proposition and not ever envisaged to just be continuing on.

Senator **Lautenberg**. I would hope that as we have encouraged their return to a stable economy that we would continue to be of as much help as we possibly can, because if we get them on an even footing, I think it would be critically important for our own concerns and interests in the Middle East.

I thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman **Domenici**. Senator Chiles.

HOW TO EXPLAIN MORE HELP FOR BOLIVIA

Senator **Chiles**. Mr. Secretary, I just have one little question I want to ask you.

Bolivia is a country which has tremendous problems, and we sympathize with them. Their economy has been politically described as "imploding." They have an inflation rate estimated to exceed 115,000 percent; the lowest per capita income in Latin America, a $3.7 billion foreign debt, and a debt service ratio of over 100 percent. They have been increasing their money supply so rapidly, I understand that the importation of bank notes from Europe is their third largest import. The present government does not seem to have any kind of economic program to deal with the kind of an economic disaster that they have. The IMF program or a bailout from the private sector is clearly out of the question.

How can we explain that we are proposing a $20 million cash transfer to Bolivia?

Secretary SHULTZ. I will have to ask Mr. McPherson to elaborate a little bit. But I think here in Bolivia, we see a situation where a country has a democratic pattern; they have just had a change in regime; we seek to encourage that process. And that regime has been taking some very difficult steps. I think some of your information is true but a little out of date.

They have excruciating difficulties, but they are trying, and we would like to help them.

Peter, perhaps you could elaborate.

Mr. McPHERSON. Yes, Senator. The situation that you set forth was fundamentally the pattern as of this summer. In August, a man by the name of Paas, who is actually a 78-year-old man, was elected to the presidency and has followed some really dramatic economic changes. The inflation you speak of is now down to just a few percentages a month. The whole country has changed very importantly.

Moreover, Paas is taking a very aggressive position on the drug eradication—it is not as much as we want done yet, but it is really an amazing case. I was down there just a few weeks ago and had a chance to review it directly. What you have is the old pattern, and now we have got a new case, Senator.

Senator CHILES. Thank you.

Thank you, Mr. Chairman

Chairman DOMENICI. Mr. Secretary, I did want to congratulate you and your people on the graphic display you have passed out of success in democratization in Latin America from 1976 to 1986. The chart shows that most of the countries there were not democratic or significantly free, and in 10 years, it is almost entirely democratic and open. I think that is graphic evidence that we are succeeding, and it also is significant evidence that economic support for Latin American democracy is a very important part of our foreign policy in terms of helping them get through some tough times.

Unless you have anything further to say, we thank you and your assistants for your patience and valuable assistance today. We stand in recess until the call of the Chair.

Thank you very much.

[Whereupon, at 12:05 p.m., the committee was adjourned, subject to the call of the Chair.]

WRITTEN QUESTIONS FROM SENATOR LAUTENBERG TO SECRETARY SCHULTZ AND THE RESPONSES

QUESTION: What is the U.S. policy regarding the issuance of entry visas for members of the PLO and members of other terrorist groups?

ANSWER : U.S. law requires that visas be denied to terrorists under Sections 212(a)(27), 212(a)(28)(F), and/or 212(a)(29) of the Immigration and Nationality Act.

The PLO and most of its affiliates are considered to be within the purview of Section 212(a)(28)(F) of the Act. In keeping with the UN Headquarters Agreement, however, PLO members who come to the United Nations General Assembly for UN business are normally granted temporary waivers of their ineligibility by the Immigration and Naturalization Service and are issued single entry visas. Their travel in the U.S. is restricted to within the twenty-five mile radius of Columbus Circle, New York City.

Temporary waivers and single entry visas may also be granted to other PLO members when there are humanitarian considerations or other circumstances where entry is deemed to be in the U.S. interest. Normally, however, waivers are not recommended for PLO members.

In consultation with intelligence and security agencies, the Department of State also denies visas to all known terrorists whatever their nationality or organization. Identified terrorists are listed in a world-wide automated look-out system which must be checked before a visa may be issued.

In making its determinations the Department of State works closely with the counter-terrorism sections of the intelligence community. Every application is considered individually in the light of all the facts and circumstances and the provisions of the INA.

Q. Why hasn't the Palestine Information Office in Washington registered under the provisions of the Voorhis Act? Isn't that failure to register a violation of U.S. law? If not, why not?

A. As 18 U.S.C. section 2386 (the Voorhis Act) falls within the jurisdiction of the Attorney General, this question should be addressed to the Foreign Agents Registration Unit of the Department of Justice.

APPENDIX

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AMERICAN LUNG ASSOCIATION
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STATEMENT OF

THE AMERICAN LUNG ASSOCIATION AND THE AMERICAN THORACIC SOCIETY

TO THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

RE: THE PRESIDENT'S PROPOSED FY 87 BUDGET

MARCH 4, 1986

National Headquarters: 1740 Broadway, New York, N.Y. 10019 • James A. Swomley, Managing Director

The American Lung Association and its medical section, the American Thoracic Society, appreciate this opportunity to comment on the President's proposed FY 87 budget and the effect this budget would have, if enacted, on the health programs and services supported by the federal government.

ALA will focus its concerns on those programs relative to the prevention and control of lung disease. These diseases constitute a devastating and growing health problem in the United States. Lung diseases range from the chronic and often fatal diseases of the newborn, to serious infectious diseases, to those related to environmental exposures--workplace and ambient air, and to diseases attributable to cigarette smoking, the leading cause of preventable death. Including lung cancer and emphysema, lung diseases althogether rank third among the leading causes of death and sixth among the conditions responsible for premature retirement due to disablility. COPD--Chronic Obstructive Pulmonary Disease--is the most rapidly increasing of the 10 leading causes of death. The direct and indirect costs of lung diseases will be a staggering $36.5 billion in 1985.

Grim as this statistical picture appears, it is not hopeless. Federal programs of disease prevention, health promotion, biomedical research, environmental and occupational health hazard control, and professional education and training have greatly improved the detection and treatment of many of these diseases. Furthermore, there are many exciting advances at the threshhold of being translated into new diagnostic and treatment modalities.

Our comments, Mr. Chairman, will primarily explore the impact of the President's proposed budget on the federal biomedical research program within the National Institutes of Health. Additional comments will focus on the Environmental Protection Agency's Air Program and conclude with the impact of the proposal to eliminate once again the program for Tuberculosis Project Grants administered by the Centers for Disease Control.

THE NATIONAL INSTITUTES OF HEALTH

The National Institutes of Health represent the largest source of funding for lung related research in the United States. This research program--principally within the National Heart, Lung and Blood Institute--has contributed significantly to the remarkable progress made in the past decade towards unmasking the basic physiological events underlying the development of lung diseases, and devising treatments and preventive strategies for these diseases. Such progress translates into great savings in the cost of caring for patients disabled from lung disease and in the cost of the loss of their productivity.

The largest program in lung related research is conducted within the NHLBI's Division of Lung Diseases. Other major research programs on lung cancer, allergic and immunologic diseases, and environmental related lung diseases are conducted by the National Cancer Institute, the National Institute for Allergy and Infectious Diseases, and the National Institute for Environmental Health Sciences. Below is a summary of the major sources of NIH supported lung research developed by the Interagency Technical Committee, Working Group on Lung Disease (data is provisional for FY 85):

NIH Supported Lung Research

Institute	FY 85	% of Support	# of Lung Projects
NHLBI	128.15M	57.3	716
NCI	29.48M	13.2	164
NIAID	13.35M	6.0	88
NIEHS	11.71M	5.2	66

The President's FY 87 budget calls for a funding level of $4,936,157 for the NIH. This represents an approximate 8% reduction from the FY 86 appropriated level or a 4% reduction if the sequestration order is implemented as mandated by the Gramm/Rudman Act. This level of reduction will significantly impact the ability of the nation's research programs to address many public health and disease related problems. Using the FY 86 appropriated levels, the level of reduction for lung related research is even more devastating when reviewd in the aggregate. Below are percentage reductions for those Institutes supporting the majority of lung related research:

Reductions in Federal Support for Lung Research

Institute	**FY 86**	**FY 86 (G/R)**	**FY 87**
NHLBI	**859.2M**	**-4.5%**	**-8.6%**
NCI	**1252.7M**	**-3.5%**	**-7.6%**
NIAID	**383.4**	**-10.0%**	**-13.8%**
NIEHS	**197.5**	**-6.0%**	**-4.9%**

Because the NHLBI and its Division of Lung Diseases is the primary source of federal funds, our comments will focus on a review of the impact of the President's proposed budget on this Institute.

NHLBI: IMPACT OF THE PRESIDENT'S BUDGET

The largest portion of the NHLBI's research portfolio is the Research Project Grants. Only modest changes have occured in this function; a reduction from the FY 86 appropriated level of 2704 competing and noncompeting grants to 2605 competing and noncompeting grants representing a 4% reduction. This limited reduction in numbers of grants is in part due to the specific language in the FY 86 appropriations bill requiring that NIH support 6100 new and competing grants. However, the funding levels have been reduced by 7% which will require that noncompeting research project grants be negotiated downward an average of 11.3%.

Reduction in the funding level of individual grants will have significant impact on the ability of individual researchers to accomplish the goals set out in their research grant. To begin with, the peer review process is extremely vigorous in cutting research grant budgets in the review process. A further 11.3% reduction will impair the scientific integrity of grants and in some cases, may make grants impossible to complete. A final comment regarding this reduction in the support of individual grants relates to the continued increase in the cost of certain types of research. Research which uses radioactive isotopes, for example, has become increasingly expensive as new methods are used to safely dispose of the waste.

Of significant concern to the ALA/ATS in reviewing the President's proposed budget reductions is that portion of the NHLBI's research program which supports Sepcialized Centers of Research--SCORs. Of the 60 Centers provided for in the budget, 24 are scheduled for competitive renewal in FY 87. Of this number, 16 are within the Division of Lung Diseases program. While the number of Centers to be funded has remained stable, the funding level is reduced by 13% from the FY 86 appropriated levels. Further confounding this budgetary dilemma is the fact that Centers are awarded for a five-year period. During the renewal process significant budget growth is anticipated to counter previous inflation and allow for adequate resources throughout the period of the award. The President's budget allows $75,757,000 for this function. In reality $93 million should be provided, as a minimun, to allow adequate budget resources and enable the Centers to achieve their research objectives.

The SCOR program is a unique research mechanism which includes both basic and clinical research emphasis to ensure that advances in the basic sciences are quickly translated into applications at the clinical level. This research mechanism directly benefits patient and public health. A major reduction of this research mechanism will result in the slow-down of direct application of research findings and subsequent benefits to patients. Attached is a fact sheet on the NHLBI SCOR program in lung disease. A more detailed report is also available, should you wish to review it.

Lastly, a research function of interest to the ALA/ATS is that of research contracts. The President's budget shows a 3% reduction in funding from the FY 86 appropriated levels. This apparently modest reduction is misleading when the types of research supported by this function are considered. Research contracts support clinical trials, a research activity which studies and evaluates relevant clinical problems.

Within the Division of Lung Diseases, a major clinical trial was just initiated to study Chronic Obstructive Pulmonary Disease--COPD, the most rapidly increasing of the 10 leading causes of death in the United States. This clinical trial represents an eight year obligation by the NHLBI to determine if those persons considered to be most susceptible to the development of COPD can avoid these problems if they stop smoking, and, when deemed necessary, use certain medications.

During the first year, moderate costs have been encountered as the clinical trial study design and research protocol were developed. During the second year, major budgetary growth is necessary to absorb the costs related to equipment acquisition and patient recruitment--

critical start-up activities if the trial is to be completed successfully.

A level of funding at approximately $75 million would allow continuation of the curent level of support. This amount, however, would still cause significant limitations to start-up activities.

Additional Concerns

There will be further impact on the federal biomedical research program if the trend of drastic reductions in the NIH budget is not curtailed. As funding levels fail to keep pace with the total obligation for research activity, as an example, it is anticipated that specific Institutes will become very conservative in their approach to funding new initiatives, expecially research activity with long term obligations as in the areas of clinical application and epidemiology. An example is the so called "Six Cities Study" funded by the NIEHS for the past 12 years. It is a longitudinal epidemiologic study which is looking at indoor/outdoor air pollution levels correlated to measures of pulmonary function in children. The data base generated by this study is substantial and has been widely cited in many of the supporting documents for environmental regulatory action. Such a research program obligation may not be considered for funding in the future if funding levels are not stablized with an adequate margin of growth.

THE ENVIRONMENTAL PROTECTION AGENCY: AIR PROGRAM

The EPA is charged with implementing this nation's environmental statutes. Of particular interest to the ALA/ATS is the Agency's enforcement of the Clean Air Act and its limited research activity in support of this regulatory mandate.

The President's proposed budget for FY 87 reduces the Air Program by 7.9% from the FY 86 appropriated levels. This reduction leaves a budget insufficient to aggressively pursue EPA's stated highest prioirty: to implement a comprehensive national strategy to control toxic compounds in the air and maintain an adequate level of programming to achieve attainment of the National Ambient Air Quality Standards, the cornerstone of the Act.

Of particular concern to the ALA/ATS is the President's proposed reduction of the Research and Development Program in Air by 7.7%. Such a reduction in a program already beset with major problems would be ruinous. The strictures already placed on the Research and Development budget and current program management problems severely limit EPA's ability to successfully complete necessary research activities to support its regulatory mandate.

EPA's research program is not funded and managed in a manner similar to that of the NIH. EPA can obligate funds for only one year, thus limiting the type and volume of research to be initiated. Further, at any point in the fiscal year monies can be re-directed by decisionmakers from the Assistant Administrator for Research and Development through individual laboratory directors, to purposes other than originally set out in the adopted research program.

The severe budget reductions have also forced EPA to reasses its research priorities. This is very unfortunate. As an example, EPA is decreasing support on mobile source pollutants. Its rationale is that a sufficient data base exists to maintain its regulatory activities. This may be a very short sighted reassessment. Recent work in EPA's own laboratories on ozone health effects has identified a possible link between ozone and inflammatory processes in the lung leading to the hypothesis that acute exposures to ozone may contribute significantly to the development of chronic lung disease. There is no existing data base and no current funding is anticipated to begin any initial investigation.

CENTERS FOR DISEASE CONTROL: TUBERCULOSIS PROJECT GRANTS

The ALA has an interest in the many public health programs administered by the Centers for Disease Control. A specific focus for the purpose of reviewing the President's budget will be the program of Tuberculosis Project Grants, first authorized by Congress in 1982. This program provides cooperative agreements to state and local health departments in high incidence areas for TB control activities.

Originally organized to combat this dreaded disease, ALA continues its commitment to the eradication of TB. ALA is again surprised by the short sighted action of the Administration to eliminate funding for this program.

In 1980, 28,000 newly diagnosed cases of TB were reported in the United States representing a 0.6% increase over that reported in 1979. Such an increase has only been seen twice in the last 25 years. A major contributing factor was the large number of cases diagnosed in the Indochinese refugee population. In 1981, the rate declined 6% to 27,373 cases and in 1982 a further decline of 7% was noted. This decline continued in 1983 and 1984 with 6.7% and 7.8% decreases respectively; decreases, noted by ALA, anticipated with an adequately functioning TB control program.

In 1985 it appears that once again there will be no decline in TB morbidity. Provisional data indicates that, if seen, the decline will be as little as 2%. Speculation is that once the data is finalized, this very small decline will disappear. In addition to the problems of drug resistant TB, TB among immigrants and refugees, and TB in children, new problems have emerged related to an increasing incidence of infection in those with the AIDS virus, and outbreaks among the homeless.

The program of TB Project Grants should be intensified in light of the current and emerging transmission problems rather than eliminated as the President proposes. Moreover, the program has undoubtedly saved third party payers millions of dollars in hopsitalization costs. For example, Connecticut, Los Angeles and Massachusetts report annual savings of $81,000, $500,000, and $250,000 respectively through the use of outreach wokers and directly observed therapy. Additionally, there has been much more widespread use of modern short-course chemotherapy regimens since the initiation of the TB Project Grants.

Transmission of TB in the United States should have ended years ago. The ALA recommends that the authorized level of $10 million be provided for TB Project Grants for FY 87.

CONCLUSION

As is clear from our comments, the federal government provides a significant source of funding to a wide range of programs directly impacting the prevention and control of lung disease. In the absence of adequate federal support, neither state nor local governments, nor the private sector are financially capable of continuing this level of programming. Furthermore, while it may appear tempting to assume that the private sector could be encouraged to accept some responsibility for support, this support might come at the high price of limited investigation or reversal of research direction. Consider what might be the knowledge base regarding the health effects of cigarette smoking, as an example, if the research effort had been directed by the tobacco industry.

Reductions to the extent proposed by the President will lead to the dismantling of the federal research program. This reduction would occur at a time when international industries are developing around our new biomedical technologies, negatively impacting on this economic growth. Great advances made over the last twenty years are now being capitalized upon in cell biology, molecular biology, and other biosciences. This past effort has clearly placed the United States in the forefont internationally and the level of effort must continue if our federal research program and the supporting industries are to remain competitive.

The health and biomedical research programs of the federal government give strength and leadership to our entire health care system. Adequate resources should be provided for continuing these programs at a level of priority indicated by the magnitude of lung diseases in the United States. Attached is a fact sheet summarizing the ALA/ATS appropriations recommendations for FY 87.

We are now at the threshhold of remarkable breakthroughs in biomedical research which will lead to significant improvement in the health of the nation. We have a sound basis for environmetal protection. The tools to eliminate what was once this nation's leading cause of death--TB, are available. Thus, now more than ever, vigorous support and adequate resources are essential.

AMHPS

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STATEMENT

OF

WALTER C. BOWIE, D.V.M., PH.D.

DEAN
TUSKEGEE INSTITUTE SCHOOL OF VETERINARY MEDICINE

AND

PRESIDENT
OF
THE ASSOCIATION OF MINORITY HEALTH PROFESSIONS SCHOOLS

PRESENTED TO THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

CONCERNING

BUDGET PROPOSALS FOR FISCAL YEAR 1987

ON

MARCH 1, 1966

Mr. Chairman, this is in response to your recent request asking for our response to the President's budget proposal for fiscal year 1987.

The Association of Minority Health Professions Schools (AMHPS) includes the Morehouse School of Medicine, Xavier University College of Pharmacy, Meharry Medical and Dental Colleges, Florida A&M University College of Pharmacy, Texas Southern University School of Pharmacy, Charles R. Drew Postgraduate Medical School, and the Tuskegee Institute School of Veterinary Medicine. We all rely heavily upon federal institutional and student aid programs. The eight institutions of our Association have graduated 43% of the nation's black physicians and dentists, 50% of the nation's black pharmacists, and 90% of the nation's black veterinarians.

The President's budget proposal for fiscal year 1987 for the training of health professionals, Mr. Chairman, is again highly unrealistic, and although I hesitate to say so, is a real slap in the face to minorities in the nation. The President's proposal to completely zero out support for health professions education is a clear demonstration of the callous views of the Administration toward the goals of establishing a degree of parity among blacks and whites in the health professions. Further, the President's budget proposal is also an indication of the Administration's confusion and misunderstanding of the real health and education disparities in the nation. Currently, in this nation there is a significant gap in health status among blacks and whites in the nation. Black infants are twice as likely to die in their first year as are white infants. Life expectancy for blacks is significantly lower than that of whites.

The Department of Health and Human Services recently established an Office of Minority Health under the Assistant Secretary for Health office. The charge of this office is to recommend federal policies which seek to reduce the significant health status disparity among blacks and whites, and to implement those recommendations made by the HHS Secretary's Task Force on Black and Minority Health. How can the Administration recognize the severe problem of health status by establishing this office, while proposing a budget that completely wipes out all of the programs that provide resources to the institutions that train minority health professionals, or eliminates grants or loans to minority students who attend our institutions? It has been documented that the best means of closing the health status gap is access to health care for minorities. Black health professionals are more likely to locate their practices in areas that are more heavily populated by blacks and other low-income minorities, thus providing this access. The Administration proposals run completely opposite of this reasoning. Realistically, the Administration's poor answer to the significant health status gap is to open a small office of minority health and shut everything else down. Believe me, Mr. Chairman, this will not work.

Thank you for this opportunity to present the views of the Association of Minority Health Professions Schools. We appreciate your efforts in the past, now, and in the future to fairly administer federal health policy.

Statement of the Chamber of Commerce of the United States

ON: FISCAL YEAR 1987 BUDGET

TO: SENATE BUDGET COMMITTEE

BY: FRANK L. MORSANI

DATE: MARCH 3, 1986

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The Chamber of Commerce of the United States is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents almost 180,000 businesses plus several thousand organizations, such as local/state chambers of commerce and trade/professional associations.

More than 91 percent of the Chamber's members are small business firms with fewer than 100 employees, 57 percent with fewer than 10 employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business--manufacturing, retailing, services, construction, wholesaling, and finance--numbers more than 12,000 members. Yet no one group constitutes as much as 29 percent of the total membership. Further, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the 56 American Chambers of Commerce Abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of its members serving on committees, subcommittees and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT
on
FISCAL YEAR 1987 BUDGET
for submission to the
SENATE BUDGET COMMITTEE
for the
U.S. CHAMBER OF COMMERCE
by
FRANK L. MORSANI*
March 3, 1986

The U.S. Chamber of Commerce is pleased to have the opportunity to comment on the Fiscal Year 1987 (FY '87) budget and to share with you our recommendations for meeting the requirements of the Gramm-Rudman-Hollings amendment by imposing firmer limits upon the growth of government spending.

Summary

The chief cause of federal budget deficits is the relentless growth of federal spending. Our past difficulties in solving this problem led to the recent passage of the Gramm-Rudman-Hollings amendment. The effective solution to meeting the mandates of Gramm-Rudman-Hollings is to impose firm limits on the growth of government and encourage the current economic expansion. Anything less than this - and I include tax increases in this category - will be ineffective and will reduce the prospects for economic growth.

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*Chairman of the Board, U.S. Chamber of Commerce and President, Precision Enterprises.

The main objective of deficit reduction should be economic growth. Nothing can help all Americans more than a healthy, growing economy that produces more employment and more wealth for all of our society. All the government jobs programs of recent years, for example, pale into insignificance compared to what the current economic recovery has done to help people find jobs. Since 1982, 9.9 million new jobs have been created, bringing our current work force to 109 million, the highest in our history. Every time we cut back government to reduce the deficit, we must consider the trade off -- that trade off is economic growth, the best anti-poverty program we can devise. While we share your concern about projected deficits, we view these as a symptom of a larger and more severe problem -- government spending, which during the 1980's has outstripped the growth of the economy.

Since 1980 the real growth of federal spending has averaged 3.9 percent annually, much more than the real growth of the economy, which averaged 2.3 percent Also, since 1980 tax revenues have increased by $217 billion, an increase of 42 percent. However, federal spending has gone up by more, rising by $355 billion, an increase of over 60 percent. This suggests to us that government spending is the chief cause of the deficit and that better control over outlays is the only solution.

This approach is also consistent with what the public desires. It overwhelmingly voted for a president in 1984 who promised to prevent the federal government from taking a larger share of their income with higher taxes. The public knows that the economy functions better when it has greater control over its income. It also knows that the sources of economic growth lie in the enterprise and creativity of the people, not in the hundreds of programs administered in Washington.

We hope that Congress will use the Gramm-Rudman-Hollings amendment to achieve what the public desires. The Congress demonstrated great courage in passing Gramm-Rudman-Hollings. It can continue to act in a fiscally responsible manner by reducing the costs associated with hundreds of federal programs. In this way it is possible to avoid tax increases and keep our economy growing.

In anticipation that the Congress will be looking for opportunities to reduce the growth of federal spending, the U.S. Chamber and other major business associations will continue to lead the Deficit Reduction Coalition (DRC) toward the goal of achieving dramatic reductions in government spending growth rates and deficits over the remainder of the decade.

The Chamber believes that the President's budget for FY '87 provides a useful guide for future budget deliberations. We applaud the President for proposing a bold budget plan for the next fiscal year and concur with his objective of meeting the Gramm-Rudman-Hollings requirements with spending reductions. His resolve to steer clear of tax increases demonstrates his commitment to economic growth and freedom of choice.

However, we also believe that the President's budget does not go far enough. Further reductions and managerial efficiencies within the defense budget should be pursued, and a one-year cost-of-living adjustment (COLA) freeze should be extended to Social Security.

Although programs important to our membership will bear some of the burden through substantial cuts, we are prepared to accept major changes in these programs if they are part of a comprehensive and far-reaching effort to reduce the deficit.

I. Fiscal Choices

Federal budget policy in 1986 brings us to a crossroads. Record deficits, the failure to control the growth of federal spending, and the emergence of the Gramm-Rudman-Hollings amendment confront us with a critical choice. The choice is between a federal budget policy that continues to increase the government share of the public's income or a policy that places more control over resources in the hands of individuals.

The Chamber believes that the public prefers the latter. This preference is revealed in the election in 1980 and again in 1984 of a President who endorsed a policy of limited government and lower taxation. It wants more choice over how its income is spent and how resources are allocated. It knows that when it has greater choice in these decisions, the economy functions better and that prosperity does not reside in a society where growing control over resources is routed through federal programs in Washington.

The kind of federal budget policy that produces the results we desire is no great mystery. It is a policy that stresses economic incentives, the role of the entrepreneur, and job creation. In order to achieve these goals, we must pursue a policy of limited federal spending and moderate taxation. Only when we lift the burden of excessive government and taxation are economic incentives nourished and the economy prospers.

The experience of many nations around the world attests to the validity of this view. For example, many European nations have ignored the dictum that economic prosperity goes hand in hand with limited government and low taxation, carrying public expenditures and taxation to exorbitant levels. Most of these nations are now in the midst of economic stagnation. Total government expenditures in Europe, as a percentage of Gross National Product (GNP), averaged 33 percent in the early 1960's and now stand at over 50 percent of GNP. Whereas economic growth rates in Europe averaged over 5 percent in the 1960's, these rates have tumbled in the 1980's to levels that are commonly below 2 percent. The results have been dire. As an example, the United States economy has created 9.9 million new jobs since 1982, but Europe has created no new net private jobs in the last 20 years. In Europe, the percentage of the working age population with jobs has shrunk, and the unemployment rate has continued to increase since 1982 despite the economic recovery.

II. The Sources of Our Fiscal Problems

The major source of our fiscal problems is rooted in the relentless growth of federal spending. It took 160 years for federal spending to claim 10 percent of America's GNP, which it did in 1940. Since that time federal spending has risen to more than 24 percent of GNP. In recent times the trend continues. For example, federal spending, including Social Security, as a percentage of GNP stood at 20.5 percent in 1979 but has advanced to 24.0 percent in 1985. One major implication is that federal government growth has surpassed the growth of the economy.

Such facts are hardly a secret, and Congress has often tried to control the growth of federal spending. However, its good intentions have not always materialized. The problem is that Congress faces serious difficulties in implementing its own budget resolutions. In fact, over the past five fiscal years, actual spending has surpassed budget resolution targets by an average of $24 billion a year. This year's budget resolution is no exception. Recent analysis indicates that spending, without the Gramm-Rudman-Hollings sequester, would exceed the 1986 budget resolution by approximately $27 billion.

In large part, these problems are related to the federal budget process and the growing influence of special interests. Representative democracy has the unfortunate side effect of making it possible for special interest groups to push through programs that create substantial benefits for themselves but inflict greater costs upon the rest of the electorate. James Madison recognized this problem as the "violence of the faction." This refers to the ability of a well organized minority to profit by legislation that disperses the cost of a federal program over the entire electorate. The former group has every incentive to organize because its per capita benefits are high, and the latter fails to organize because per capita costs are insignificant. The result is that many federal programs of questionable value are enacted.

The compromise FY '86 budget resolution, passed by Congress in late July, failed to incorporate important structural changes, such as a freeze on Social Security and other retirement COLAs. It substituted domestic program freezes and unspecified reductions for program terminations. Nearly half of the cuts came from defense spending.

The effects of the 1986 budget resolution have since become clear. Federal spending is on a path that will breach the budget resolution by a wide margin. Congress has found it difficult to enact a reconciliation bill to enforce the nearly $15 billion in proposed budget reductions. As a consequence, most of the domestic spending reductions contained in the budget resolution are not being enforced.

The recently enacted farm bill illustrates the difficulties associated with enforcing a budget resolution. It is expected that farm support programs will cost $20 billion in 1986, nearly $8 billion more than the amount specified in the budget resolution. The farm bill and the failure to enact reconciliation mean that the 1986 budget will be well over the amount specified in the budget resolution.

Such slippage, I believe, is one of the chief reasons why a large, bipartisan majority of both houses finally enacted the Gramm-Rudman-Hollings amendment. Something more was needed. When it became apparent that the 1986 budget resolution would not cut spending to the extent intended, it was time to consider procedural changes. Gramm-Rudman-Hollings, by setting binding budget targets, hopefully will lead to better results. Moreover, we feel the sequester will take some of the political heat off Congress. Special interests will know that Congress has no other choice.

III. Opportunities to Reduce Spending Growth and Cut the Deficit

The Gramm-Rudman-Hollings amendment forces us to confront the issues. The Chamber believes that Congress can take advantage of this opportunity to reduce the growth of federal spending. Nearly every portion of the federal budget contains areas worthy of consideration for budget reduction. Reputable sources, such as the Congressional Budget Office (CBO), the General Accounting Office (GAO), the Office of Management and Budget (OMB), the Heritage Foundation, the Brookings Institute, the Grace Commission and the Senate Finance Committee, have documented spending reduction opportunities that easily exceed $100 billion in one year alone.

The Chamber believes that Congress should avail itself of these opportunities. We strongly encourage you to take advantage of the numerous spending reduction proposals put forward by these organizations. If one considers the CBO and OMB estimate that the 1987 deficit will be less than $40 billion over the target deficit of $144 billion, one can agree that this is not an exceptionally large amount of budget savings to accomplish in one year. More than this was attempted last year and nearly achieved.

In an effort to reach this objective, Congress once more should consider reform of entitlement programs. Such a policy is warranted in light of the large subsidies given to present retirees. Future generations will not fare so well. They will confront billions of dollars of unfunded liabilities, and they will receive a poor return on their contributions to such programs. For example, according to some estimates, today's 20-year-old will receive 72 cents for every dollar he puts into the Social Security system. Consequently, it is important that Congress implement such reforms as COLA freezes in federal pension and Social Security programs and higher co-payments and fees for Medicare beneficiaries.

In the nondefense discretionary area, substantial savings can be made in hundreds of programs ranging from Amtrak to the Rural Electrification Administration. Special attention should also be given to reducing the cost of price supports for agriculture.

We should continue to seek efficiencies within the Department of Defense. Base closures, pay reform, contract efficiencies, greater use of contracting out, and other cost savings should be pursued. A recent GAO report, for example, studied 20 Department of Defense functions that had been contracted out and found that cost savings were realized in 17 of them.

Numerous studies by the President's Private Sector Survey of

Cost Control, GAO, and CBO have discovered many areas within the Department of Defense where substantial cost savings could be achieved without jeopardizing our national security. We encourage you to continue to review these many proposals and urge their adoption where appropriate. Further, we hope that the so-called Packard Commission will soon recommend additional ways to stretch the defense dollar.

Congress should also take advantage of an exciting and relatively novel method to achieve spending reduction - privatization. Privatization refers to the process of shifting a portion of public-sector activities to the private sector. The advantage of privatization is that public programs are not eliminated but shifted to the more efficient private sector. Consequently, program beneficiaries need not be alienated through loss of service or benefits. Privatization can take many forms, such as the sale of public assets and commercial activities to private interests, contracting out, and the utilization of vouchers. Privatization can help substantially in reducing the budget deficit. For example, Great Britain's recent experiment with privatization has added over $20 billion to its treasury.

To us the message is clear. Spending cuts are preferred to tax increases. The basic prerequisite for a strong and growing economy is limited taxation. Studies by the World Bank and the Organization for Economic Cooperation and Development (OECD) indicate that those countries with high rates of economic growth have low tax rates and those with a persistent pattern of stagnation have high taxes and burdensome government. Countries that continue to grow and enrich their populations have economic systems that reward work, enterprise, and creativity. But these incentives cannot be maintained with a budget policy that feeds runaway spending by burdening workers and businesses with rising levels of taxation.

As Congress reconvenes and begins to develop next year's budget, the discussions about what to do to reduce the deficit focus increasingly on proposals to levy an oil import fee or to increase the gasoline excise tax. Admittedly, there is a certain attraction to such a tax now that oil prices have fallen so sharply. For some, such a tax is viewed as "costless," inasmuch as it could be structured such that oil and gas prices remain at the levels reached last year. To adopt such a tax, however, would deny the economy an important source of stimulus for this year and next and would be offset, in part, by diminished revenues elsewhere. Such a tax could also be regressive and have disproportionately severe impacts on some regions of the country.

An additional and compelling argument against oil and gas taxes is that they would deprive all Americans of a benefit they deserve. For over a decade, Americans have been paying the inflationary and other costs of a cartel-imposed price on oil. In addition, billions have been spent on energy conservation. After all these sacrifices, Americans deserve the benefits of falling oil and gas prices. They have earned them. Let's not deprive them of their just rewards.

Our simulations using the Washington University econometric model of the U.S. economy indicate that a $5 per barrel decline in the price of oil would add $16 billion or a half of a percent to real GNP this year and $36 billion or almost a full percentage point to real GNP in 1987. The price decline also would create an additional 800,000 jobs over this year and next and reduce the budget deficit by $10 billion dollars over the same period. The projected deficit reduction follows from the higher business and personal incomes which lead to greater tax revenues. I might note that studies of the oil price decline by Data Resources Inc. and Wharton Econometric Forecasting Associates came to essentially the same conclusions with regard to the impact on GNP.

We must realize that massive tax increases will not reduce the deficit and may even worsen it by diminishing economic growth. All too often, the logic behind a tax increase is based on a faulty accounting perspective of tax revenue. The argument is that tax revenues expand by the increase in the tax rate multiplied by the existing tax base. However, this static estimate of tax revenues fails to take into consideration the disincentive effects of higher tax rates upon the tax base. Specifically, rising tax rates mean less economic growth, less income and profits, and less tax revenue. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) illustrates this point. In conjunction with modest decreases in some spending, TEFRA, when enacted, promised a $103.9 billion deficit in FY '83 and an $83.9 billion deficit in FY '84. These targets, of course, were never achieved, in large part because actual spending exceeded targets by a substantial margin.

IV. The President's Budget and a Course for the Future

The Chamber firmly believes that there is ample room on the expenditure side of the federal budget to meet the requirements of Gramm-Rudman-Hollings. For this reason, the Chamber supports the goals of the President's 1987 budget. The key feature of this budget is its resolve to reduce the federal deficit with spending reduction and to avoid tax increases. This reflects the Administration's desire for economic growth and its recognition of the disincentive effects of taxation. We applaud its awareness of the opportunities available for spending reduction.

The President's budget focuses on the nondefense portion of the budget with special emphasis on its discretionary component. The Chamber agrees that there is much that can be accomplished in this budget area. The Chamber does so knowing that programs important to our membership will bear some of the burden through substantial cuts. The President's budget also takes the initiative in implementing privatization measures. The Chamber also believes that privatization is a creative and bountiful source of spending reduction.

Nevertheless we believe that the President's budget can be improved. While we strongly endorse his efforts to reduce spending, we believe that it is essential to go further in the areas of defense and Social Security, which together constitute over half of all spending. The inclusion of these additional measures of spending restraint will create a greater sense of equity and shared sacrifice. A budget proposal should include the following provisions:

- COLAS, including those for Social Security, should be frozen for FY '87 and should be less than 100 percent of the Consumer Price Index in subsequent years.

- Spending for nondefense discretionary programs should be reduced to achieve savings comparable to those found in the President's budget.

- Further savings in federal pay, pension, and Social Security programs can be obtained by making them more comparable to prevailing private-sector norms. CBO's recommendations along these lines are useful and include limiting the increase in Social Security bend points, lengthening the Social Security benefit computation period, reducing benefits for federal workers who retire early, and reducing in-grade pay raises for federal workers.

- Further defense savings should be achieved through managerial efficiencies and the implementation of the many recommendations provided by the Grace Commission, GAO, and CBO.

- Farm subsidy programs must be fundamentally reformed to reflect savings comparable to those recommended for other programs.

- An aggressive privatization program should be carried out, using such tools as sales of assets and government commercial enterprises, contracting-out, and vouchers.

- Means-tested programs should be allowed an adjustment for inflation and new beneficiaries. However, to the extent possible, the recommendations of the President and others to improve targeting, efficiency, and management should be adopted.

With this prologue, the Chamber is delighted to find that the President and many members of Congress intend to devote their efforts to a deficit reduction strategy that relies entirely on spending restraint. We applaud the courage of Congress in passing the Gramm-Rudman-Hollings amendment, and we will devote much of our resources over the coming months to assist you to meet its requirements.

STATEMENT OF
STEPHEN L. EDMISTON
DEPUTY NATIONAL LEGISLATIVE DIRECTOR
DISABLED AMERICAN VETERANS
TO THE
COMMITTEE ON BUDGET
UNITED STATES SENATE
FEBRUARY 19, 1986

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

On behalf of the more than one million members of the Disabled American Veterans and its Ladies Auxiliary, I am pleased to have this opportunity to discuss the budget request for the Veterans Administration for Fiscal Year 1987.

Let me begin by thanking you, Mr. Chairman, and the members of the Committee for permitting us to present our views on the Fiscal Year 1987 VA budget request prior to completing your work on the First Concurrent Budget Resolution.

Before specifically addressing the VA's proposed Fiscal Year 1987 budget request, Mr. Chairman, we believe that it is important to point out that the obvious driving force that has shaped this budget is the Gramm/Rudman/Hollings balanced budget amendment. Not only has Gramm/Rudman/Hollings influenced the make up of the Fiscal Year 1987 budget request, but it has also inflicted direct benefit reductions on deserving service-connected disabled veterans, their dependents and survivors in the current Fiscal Year.

Therefore, as the Committee considers the VA's Fiscal Year 1987 Budget Proposal, we urge you to fully consider taking appropriate actions to insure that VA programs and benefits that impact directly upon service-connected disabled veterans and their dependents are protected from the provisions of Gramm/Rudman/Hollings.

As you know, Mr. Chairman, on behalf of the Veterans

Administration, the President is requesting $26.6 billion in budget authority to administer the various programs and services for millions of our nation's veterans and their families in Fiscal Year 1987.

In budget authority, the VA request is approximately $408 million below the Fiscal Year 1986 level, primarily due to so called "projected savings" that include:

- * staffing reductions of more than 8,900 health care professionals;
- * a substantial decrease in the number of veterans treated as inpatients and outpatients;
- * substantial reduction in construction funds;
- * an incremental increase from 1% to 3.8% in the user fee charged to VA guaranteed home loans;
- * seeking no funding for the Veterans Job Training Program;
- * repealing the VA's authority to grant education loans;
- * closing the all volunteer force GI Bill to new enrollees;
- * a change in eligibility criteria for the VA plot allowance.

Overall, Mr. Chairman, these projected savings, coupled with other budget proposals and the Gramm/Rudman/Hollings sequestering order to become effective March 1, 1986 will clearly jeopardize the VA's ability to provide continued quality care at every medical facility in the VA health care system.

Medical Care

The Fiscal Year 1987 budget request calls for an overall decrease in funding in the VA's medical care account of $46.1 million below the Fiscal Year 1986 level.

At first glance, Mr. Chairman, it would appear that the funding reduction for VA medical care is quite small, however, when you look beneath the surface and examine the budget documents for the VA's medical care funding proposal, you discern an entirely different picture.

For example, the VA proposes to:

- treat fewer "low priority" veterans;
- reduce medical care personnel by 1%; and
- nearly eliminate beneficiary travel.

By so doing, they would reduce the number of medical care personnel by more than 8,900 and save over $500 million.

Furthermore, the loss of more than 8,900 medical care personnel translates into the loss of more than 1,300 nurses and 500 doctors and dentists, as well as other health care personnel.

As a result, the VA will treat fewer (so called) "low priority" veterans by 62,000 inpatients and 1.2 million outpatient visits, and further reduce the overall number of VA hospital and nursing home operating beds by approximately 3,000 from the Fiscal Year 1986 budget level.

Mr. Chairman, the President's proposed Fiscal Year 1987 VA budget request blatantly ignores the provisions of Section 5010(a)(1), Title 38, USC -- "The President shall include in the budget transmitted to the Congress for each fiscal year pursuant to section 1105 of title 31, an amount for medical care and amounts for construction sufficient to enable the Veterans' Administration to operate and maintain a total of not less than 90,000 hospital and nursing home beds in accordance with this paragraph ..." (emphasis added)

The budget documents reveal that during Fiscal Year 1986 the VA will operate at least 900 beds below the statutory requirements and will seek to further circumvent the law by operating 4,000 fewer beds than the law requires in Fiscal Year 1987 ... and at the same time they propose to cancel all new VA nursing home construction.

We must question, Mr. Chairman, why the VA (or OMB) is seeking such drastic reductions in VA medical care funding when their own statistics reveal they are turning away more than 30,000 eligible veterans who are seeking VA health care services each month.

In the past OMB has made it perfectly clear that they would like "to shrink the size of the system" -- but is this their real effort or do they want to simply destroy the VA health care system?

As you know, Mr. Chairman, the VA health care system has been on a serious decline for a number of years due to negative (deflated) funding. The proposed Fiscal Year 1987 medical care budget request only exacerbates this chronic state that has existed for more than a decade.

Reduced medical care funding, coupled with such proposals as drastic reductions in health care personnel, decreasing the number of veterans treated, elimination of most beneficiary travel funds, reducing the number of available operating beds and providing no new funding for the Health Professional Scholarship Program, only serve to jeopardize the quality of health care provided at each and every VA medical facility.

We note, Mr. Chairman, that the VA is again proposing legislation to (1) repeal section 610(a), Title 38, USC -- providing eligibility for hospital or nursing home care for a nonservice-connected disability if the veteran is 65 years of age or older -- (2) establishing a means test for certain categories of veterans without service-connected disabilities and (3) provide authority for the VA to collect reimbursements from private health insurers of nonservice-connected veterans receiving VA health care services.

These legislative proposals, as you know, Mr. Chairman, were addressed by the Senate and House Veterans' Affairs Committees and are currently pending in the Omnibus Budget Reconciliation Act of 1985 -- H.R. 3128.

For the record, Mr. Chairman, the DAV remains opposed to the Administrations' proposed means test. However, the DAV supports the medical care eligibility changes agreed to in H.R. 3128. These provisions, in our view, are a significant step to strengthen and enhance health care for all service-connected disabled veterans.

With respect to the proposal to authorize the VA to collect reimbursements from private health insurers -- as proposed by the VA and contained in H.R. 3128 -- the DAV remains unconvinced the VA will in fact receive revenue in excess of the administrative costs of implementing and collecting these payments.

Mr. Chairman, we encourage you, and the members of the Committee, to carefully scrutinize the Fiscal Year 1987 funding levels proposed for the VA medical care program. We believe such scrutiny will lead you to recommend realistic levels of funding (unlike that proposed by the President) that will acknowledge the importance of providing timely, quality medical care services to the nation's eligible veterans.

Construction

The VA's Fiscal Year 1987 construction request is $465 million, some $332 million below the $797 million Fiscal Year 1986 level.

Mr. Chairman, while we support full funding of the VA's request for construction programs we are, quite frankly, seriously concerned that this type of construction request fails to adequately address the needs of the aging capital plant of the VA health care system.

Furthermore, while more and more elderly veterans are seeking nursing home care from the VA, this construction request reflects a new OMB mandated policy which directs the VA to shift the responsibility for VA nursing home care to state and community nursing facilities. As a result all new VA nursing home projects have been cancelled.

The VA's Fiscal Year 1987 budget request does contain, however, a $21.5 million increase (over the Fiscal Year 1986 level) in grants for construction of state extended care facilities. The VA's request of $42.4 million will provide for an additional 120 nursing home care beds, 126 convertible domiciliary/nursing home beds and 150 domiciliary beds.

As you know, Mr. Chairman, this particular federal/state sharing program has been a tremendous success in terms of encouraging states to actively participate in the nation's commitment to providing quality care to her eligible veterans. However, the DAV does not believe the federal government should relinquish its primarily responsibility for veterans health care -- especially in the nursing home care area.

Additionally, we have noted that the VA continues to reduce the number of medical, surgical and psychiatric beds, while at the same time providing modest increases in the number of intermediate and nursing home care beds, to include conversion of some existing hospital beds to nursing home care beds.

While the DAV does not object to some realignment of operating beds we trust an appropriate balance will be maintained to meet the acute, intermediate and long term health care needs of all eligible veterans.

Mr. Chairman, the VA construction request for Fiscal Year 1987 simply does not go far enough to allow the VA to accomplish what must be done if the health care system capital plant -- which represents a multi-billion dollar investment on the part of the American taxpayer -- is to remain viable.

Proposed Legislation

The Administration's Fiscal Year 1987 budget request proposes legislation, in addition to that which I have previously discussed, that would provide for (1) an increase of 3.7% in the rates of Disability Compensation and Dependency and Indemnity Compensation (DIC) effective December 1, 1986; (2) increasing the loan origination fee incrementally from 1% to 3.8% by 1990; (3) changing eligibility for the plot allowance so that it would be the same as the burial allowance; (4) repealing the VA's authority to make education loans; and (5) closing the All Volunteer Force GI Bill to new enrollees and reopen the Post Vietnam Era Education Program.

The DAV is pleased with the Administration's proposed cost of living adjustment in the rates of Disability Compensation and DIC benefits -- in recognition of the special consideration service-connected disabled veterans and their survivors should be given.

Accordingly, Mr. Chairman, the DAV supports the enactment of legislation that would provide disability compensation and DIC recipients with a cost of living adjustment in line with the rise in the Consumer Price Index effective December 1, 1986.

As noted, the Administration has again proposed increasing the home loan guarantee program users' fee incrementally from 1% to 3.8% by 1990.

We believe the Committee should carefully evaluate the adverse impact this proposal will have on Vietnam veterans, who are the primary beneficiaries of the program today and, should it be rejected, we respectfully request that the Department of Veterans Benefits be exempted from absorbing the funds associated with the proposed legislation.

However, as a result of the sequestering actions of Gramm/Rudman/Hollings that directly impact on the VA home loan program, and are scheduled to take effect on March 1, 1986, it would appear the entire home loan program is doomed for the remainder of Fiscal Year 1986 ... unless Congress takes action to relieve the problem.

Veterans Employment Programs

Mr, Chairman, we have also reviewed the proposed budget for veterans' employment and training programs administered through the Office of the Assistant Secretary of Labor for Veterans Employment and Training.

Before proceeding, however, I wish to express our disappointment with the Veteran Administration's failure to request funding for the Veterans Job Training Act for Fiscal Year 1987. The reasons cited by the VA for not requesting additional funds -- (1) a significant drop in unemployment of Korean conflict and Vietnam era veterans and (2) the program unnecessarily augments job services for veterans by the VA and other government agencies -- reiterates, in our view, the Administration's continued lack of support for this important employment program for veterans.

With respect to the Office of Assistant Secretary of Labor for Veterans' Employment and Training, the Administration has proposed a Fiscal Year 1987 budget request of $ 13.1 million. This amount will fund 279 positions -- a reduction of 3 from the current Fiscal Year authorized level of 282.

As you know, the Office of Assistant Secretary of Labor for Veterans' Employment and Training also has responsibility for distributing the funding for Disabled Veterans Outreach Program (DVOP) and the Local Veterans Employment Representative (LVER) program.

In this regard, the Fiscal Year 1987 budget proposes $69.4 million to support 1,894 DVOP positions. The LVER program, on the other hand, is slated for a reduction of more than $6 million from the Fiscal Year 1986 level. The Fiscal Year 1987 LVER budget request of $48.9 million will result in the loss of more than 200 full-time equivalent positions and, in our view, will definitely impact adversely on services provided to veterans.

Mr. Chairman, we are concerned that continued employment services to veterans may be reduced due to the overall decline in personnel system wide. In this regard we urge the Committee to continue its support for full funding of the DVOP and LVER programs.

Conclusion

In closing, Mr. Chairman, in addition to the views we have already set forth with respect to the VA's proposed Fiscal Year 1987 budget request, I want to further emphasize and underscore our very serious concern for the VA health care system and the devastating effect this budget (if approved as proposed) spells for those eligible veterans who rely on the system for medical care.

We urge the Committee to favorably recommend to your colleagues in the Senate levels of funding in the First Concurrent Budget Resolution that realistically and adequately address the needs of all programs administered by the VA.

Again, Mr. Chairmain, I wish to thank you and the members of the Committee for providing us this opportunity to express our view on this most important subject.

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Mortgage Bankers Association of America

STATEMENT OF

the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

for submission to the

COMMITTEE ON BUDGET

of the

UNITED STATES SENATE

on

The Fiscal Year 1987 Federal Budget

February 26, 1986

The Mortgage Bankers Association of America respectfully submits this Statement for inclusion in the hearing record with respect to its views on the impact that FY 1987 budget proposals, recently submitted by the President to Congress, would have on housing and mortgage finance. MBA is the trade association of the Nation's mortgage banking and real estate finance industries.[*]

Our comments will focus on our strong opposition to new or increased user taxes on the Federal mortgage credit programs of the Federal Housing Administration (FHA) and the Veterans Administration (VA), and the secondary mortgage market programs of the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA), and the Federal Home Loan Mortgage Corporation (FHLMC). Further, we will discuss the necessity of establishing sufficiently high credit budget limits for the non-subsidized, user-fee supported FHA mortgage insurance and GNMA mortgage-backed security (MBS) guaranty programs, as well as for the VA entitlement-based home loan guaranty program.

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[*] The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of housing and other real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- Mortgage Banking Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Insurance Companies
- Life Insurance Companies
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

There is no doubt that the current high deficits are unsustainable and the compounded impact of those deficits will create unprecedented problems for this Nation's economy. This year will present tough budget choices to the Congress as it reviews proposed spending cuts mandated by the deficit targets contained in the Gramm-Rudman Balanced Budget Act and the tax reform proposals currently being considered by Congress. MBA strongly supports efforts to reduce the deficit. To this end, we have supported spending cuts wherever possible, stressing that all programs, including Social Security, defense, and cost of living adjustments (COLAs) should bear a fair share of necessary cuts. If these are not sufficient to accomplish deficit reduction, Congress should be prepared to increase taxes, but such increases should be broad-based and not focused on any one sector of the economy.

USER TAXES

An item of major concern to MBA as the trade association responsible for preserving an adequate and affordable supply of mortgage credit is the Administration's proposal to impose so-called "user fees" on the home mortgage insurance and guaranty programs of the FHA and the VA, as well as the secondary mortgage market operations of GNMA, FHLMC, and FNMA. The specific proposals are described in detail in Appendix A to this Statement.

Federal Housing Administration

The concept of a user fee must be tied to the cost of providing a service. In that sense, the FHA unsubsidized mortgage insurance programs have always been subject to user fees because the mortgage insurance premiums that are charged to borrowers have always covered the costs of operating these programs, including administrative expenses such as salaries, overhead, etc., as well as losses attributable to default claims that must be paid. The Mutual Mortgage Insurance Fund is a substantial reserve fund of $3.7 billion that ensures that these programs will operate on an actuarially sound basis. Thus, the cost of providing the service that the Federal government offers—mortgage insurance—is fully covered at present by user fees. Yet this proposal would increase those fees so that the Federal government would derive a larger profit from these program operations. Some call that revenue enhancement, but we believe it boils down to a tax on homeownership. And that tax is focused on those who can least afford it—moderate-income homebuyers at the lower end of the scale. The average FHA loan in 1984, the latest year for which statistics are available, was approximately $57,581 and many FHA borrowers are first time homebuyers who need the FHA low-downpayment program to get their foot in the homeownership door. The maximum loan that FHA may insure is $67,500 and up to $90,000 in designated high cost areas; these limits serve to focus the benefits of the FHA program on those who need them.

In addition to user fees, the Administration's FY 1987 budget includes a proposal that would eliminate the provisions in current law that allow FHA borrowers to finance the up-front mortgage insurance premium (MIP) and closing costs, and would establish an income limitation of $40,000 per year for FHA borrowers. The effect of this trio of FHA proposals would raise the cost of participating in the program, while simultaneously limiting participation to those least likely to be able to afford the "new" program.

By itself, the proposal to limit the financing of the up-front MIP and closing costs is enough to cripple the program. Such a prohibition effectively doubles the minimum downpayment that borrowers now make, thus eliminating one of the key advantages that the FHA program offers moderate-income homebuyers.

Not only would new FHA borrowers be worse off than current FHA borrowers, they would also be worse off than borrowers with conventional, privately insured mortgages. The typical, first-year mortgage insurance premium on a fixed-rate, high-ratio conventional loan is 1 percent, with renewals at 0.25 percent. Thus, a conventional borrower, in terms of cash at closing and monthly payments, will be considerably better off than the FHA borrower. However, much tighter conventional underwriting requirements will disqualify many potential borrowers that FHA presently is able to serve.

With respect to the proposed $40,000 income limitation for FHA-insured borrowers, it should be noted that in 1985, the median income of all FHA borrowers was $35,000. Thus, nearly half the people who used the program in that year, when it was more affordable than it will be under the Administration's proposal, would not have been eligible under this income limitation. In 1986, the limit would reduce the annual dollar volume of mortgage loans insured by FHA by $9.3 billion below the anticipated 1986 volume, resulting in the exclusion of roughly 163,000 families from the program.

Currently, in order to keep risks and fees at a reasonable level, the program is open to all families so that the risks inherent in the FHA program are spread over a large number of persons with varying degrees of financial capability, rather than being concentrated on a smaller number of less financially secure persons. Without this broader degree of risk-sharing, the fees would have to be raised beyond the point of affordability in order to cover losses.

Veterans Administration

The VA home loan guaranty program is an entitlement program and is not designed to be actuarially sound. While there may be some validity in determining the actual cost of operating the VA loan program and imposing a user fee matched to the costs of operations, MBA takes strong exception with the proposal to increase the fee to 3.8 percent by FY 1990 because it would convert this worthwhile program from an entitlement to a government sponsored profit generating program.

Secondary Mortgage Market Programs

Not only would the proposals hit the VA loan guaranty and FHA insurance programs hard, but it would also impose an additional layer of fees on secondary mortgage market entities. GNMA, FNMA, and FHLMC are all chartered by Congress. Their Boards are wholly or partially staffed by presidential appointees and their purpose is carefully outlined in their Charter Acts. They may only purchase residential mortgages and are all subject to limits on the maximum dollar amount for the mortgages that they purchase.

Despite this high degree of governmental control and oversight, the budget proposes user fees that exceed the cost of operating these entities, all of which do not cost the government a penny. GNMA currently charges a guaranty fee that not only covers the costs of program operations and claim losses, but also is sufficient to set aside funds for a substantial reserve, which currently totals over $1 billion. Both FNMA and FHLMC currently charge user fees to lenders for mortgage purchases and guaranties of mortgage-backed securities, which are set at levels designed to cover FNMA's and FHLMC's costs and underwriting risks. None of these entities require any Congressionally appropriated funds to operate.

Yet these operations would also be subject to user fees, totally unrelated to program risk, under the Administration's budget proposal.

Charging fees to users of the government's housing and mortgage credit programs for the purpose of enhancing revenues is a thinly disguised tax that is targeted toward homebuyers at the lower end of the scale. These proposals will increase mortgage rates generally and thus are contrary to the Congressional purpose of fostering homeownership through these programs and entities. If Congress believes that the only avenue left to cut deficits is that of taxation, then those taxes should be broad-based—not concentrated on the home borrower.

LIMITATIONS ON CREDIT BUDGET AUTHORITY

Federal Housing Administration

For FY 1987, the Administration's budget proposes that commitment authority for the FHA mortgage insurance program be set at $50.9 billion. This is significantly less than the commitment ceiling set for FY 1986 of $60 billion. Actual activity in FY 1985 totalled $47.44 billion and FY 1986 activity is running at approximately a $65 billion annual rate. MBA projects that these programs will experience continued strong consumer demand in FY 1987, for several reasons.

First and foremost, interest rates are expected to remain at the present affordable levels in the 10.5 percent range. This has spurred not only strong homebuying demand, but has involved heavy refinancing demand by borrowers with mortgages carrying higher interest rates. Refinancing is a healthy phenomenon, because it allows borrowers to reduce monthly payments and thus reduce the risk of default under these programs. Second, FNMA and private mortgage insurers have tightened their underwriting guidelines, which has resulted in more consumer demand for the FHA product. FHA has always served the riskier borrower population, but because it carries a higher mortgage insurance premium has, nonetheless, been actuarially sound. Third, the FHA Adjustable Rate Mortgage (ARM) program has been highly successful. The FHA-ARM with its consumer protective interest rate caps of no more than 1 percent per year/5 percent over the lifetime of a loan has provoked significant borrower demand.

Under FHA, at present activity levels for FY 1986, an increase to $65 billion may be necessary. For FY 1987, MBA urges adoption of an FHA limitation of $65 billion.

Government National Mortgage Association

The GNMA-MBS program provides a means for homebuyers, primarily moderate- to middle-income families and veterans, to obtain competitive direct access to the capital markets via the secondary mortgage market. Because the GNMA-MBS is a secondary guaranty program, a restriction in the GNMA-MBS program would limit program activity in the underlying FHA and VA primary loan programs.

In FY 1984, commitments issued in the GNMA-MBS program totaled $54.6 billion. We anticipate expanded use of the GNMA-MBS program in future years, due to its widespread acceptance in the marketplace and its critical value as a role model in fostering capital market innovations. Further, the level of purchases of VA and FHA loans by FNMA, relative to its conventional mortgage purchases, has declined in recent years because the yields required by FNMA have been more than yields prevailing in the GNMA market. As a result, the GNMA-MBS has become the most important conduit for tapping private funds for investments in FHA and VA loans.

The FY 1986 GNMA-MBS commitment authority of $68.25 billion, which is scheduled to be cut by the domestic sequestration percentage to $65.31 billion is likely to prove inadequate. At current guaranty activity rates GNMA could use $80 billion in guaranty authority this year. At the end of January, four months into the fiscal year, GNMA has issued $27.3 billion in guaranties. As can be seen from the Appendix B to this Statement, GNMA activity during the first four months of fiscal year 1986 already accounts for 48.5 percent of the total commitment authority, assuming the Gramm-Rudman sequestration cuts go into effect on March 1. This will require an increase in the FY 1986 GNMA limits as early as May 1985 to prevent a program shutdown.

Because present FHA activity is estimated in the $65 billion range and VA activity at its present pace could total $18.7 billion, MBA requests a GNMA-MBS limit of $83.7 billion for FY 1987.

Veterans Administration

As previously mentioned, in past years the VA home loan guaranty program has been treated as an entitlement program and, therefore, not subject to appropriated credit budget ceilings. However, while Gramm-Rudman continues this status for VA, if sequestration takes place all loan guaranty programs—including those not subject to appropriated credit budget ceilings, such as VA—are subject to across-the-board cuts. Thus, the General Accounting Office is given the authority to estimate activity for the VA home loan guaranty program and then to apply the sequestration cut.

For FY 1986, based on current guaranty activity, it is estimated that the VA home loan guaranty program will reach a level of approximately $18.2 billion. MBA supports legislation recently enacted by Congress (S 2052 and HR 4130) that provides for an

FY 1986 ceiling of $18.2 billion. For FY 1987, MBA anticipates a level of activity of at least $18.7 billion for the VA home loan guaranty program.

SUMMARY

In summary, MBA believes that the proposed user fees are a tax on homeowners using the Federal mortgage credit programs. The proposed fees are an indirect effort to undercut the decision of Congress that the Federal government should encourage homeownership by encouraging private capital to be available to prospective homebuyers. If additional taxes are needed, they should be broad-based and not targeted to homeowners. MBA urges that all spending be reviewed, including defense and COLAs, before a tax increase is considered, but we recognize that some broad-based tax increase may be necessary. The proposed special tax, however, should be rejected, because it represents a levy on homeownership.

In addition, MBA feels obliged to alert this Committee and the Congress to the importance of allowing FHA, VA, and GNMA to fulfill consumer demand for mortgage credit. In the early 1980s, homeownership dreams were stifled by unaffordably high mortgage interest rates. This pent-up demand is now being unleashed. Many of these borrowers are purchasing their first homes because of the opportunities that the FHA and VA programs offer. Others are moderate- and middle-income families who rely on the FHA and VA programs to assure a stable, affordable supply of mortgage credit. MBA urges this Committee to adopt adequate credit budget limits for the FHA, VA, and GNMA programs so that the American dream of homeownership does not fade.

MBA appreciates the opportunity to express its views to this Committee and would be pleased to provide additional information, as necessary, for inclusion in the hearing record.

Appendix A

PROVISIONS AFFECTING HOUSING PROGRAMS

FOUND IN THE PRESIDENT'S

1987 BUDGET PROPOSAL TO CONGRESS

FHA. Increase the MIP from 3.8 percent to 5 percent in FY 1987. Additionally, in an effort to restrict the program further, the proposal would not allow the upfront MIP or other closing costs to be included in the mortgage amount. The proposal would also limit the availability of FHA mortgage insurance to families with gross incomes below $40,000. Finally, the proposal would remove authority to insure second homes and non-owner occupant loans. The budget also proposes a feasibility study for the sale of FHA.

VA. It is expected that the Administration's budget will again propose an increase in the VA funding fee from the present 1 percent to 2 percent in FY 1987, 3.0 percent in FY 1988, and 3.8 percent by FY 1990. The proposal may also include a request to cut personnel at VA offices.

GNMA. Increase the guaranty fee from the current 6 basis points to 15 basis points in FY 1987 and 20 basis points in FY 1988 and beyond.

FNMA. User taxes would be imposed on FNMA, as follows:

Debt Securities

The fee will apply to net new FNMA debt securities issuances. This is defined as:

- any increase above the level of FNMA debt securities outstanding on September 30, 1986, plus
- the lesser of:
  - FNMA debt issued prior to FY 1987 rolling over in FY 1987 and beyond, or
  - repayments and prepayments on mortgages purchased prior to FY 1987.

This fee will be increased as follows: 10 basis points in FY 1987, 30 basis points in FY 1988, and 50 basis points in FY 1989 and beyond.

Mortgage-backed Securities

In FY 1987, FNMA will be charged a fee of 5 basis points on mortgage-backed securities sold after September 30, 1986. This will increase to 10 basis points in FY 1988 and beyond on all securities sold after September 30, 1986.

FHLMC. User taxes would be imposed on FHLMC, as follows:

Non-CMO Debt Securities

The fee will apply to net new FHLMC debt securities issuances, which are defined as:

- any increase above the level of FHLMC debt securities outstanding on September 30, 1986, plus

- the lesser of:
    - FHLMC debt issued prior to FY 1987 rolling over in FY 1987 and beyond, or
    - repayments and prepayments of non-CMO-backed mortgages purchased prior to FY 1986.

This fee will be increased as follows: 10 basis points in FY 1987, 12.5 basis points in FY 1988, and 15 basis points in FY 1989 and beyond.

Participation Certificates (PCs)/Collateralized Mortgage Obligations (CMOs)

In FY 1987, FHLMC will be charged a fee of 5 basis points on PCs and new CMOs issued after September 30, 1986, and 10 basis points on net new unsecured debt obligations in 1987. This fee on CMOs will be increased to 10 basis points in FY 1988 and beyond. The fee on net new unsecured obligations will rise to 12.5 basis points in 1988, and to 15 basis points in 1989 and beyond.

Appendix B

GNMA Monthly Activity Report
(Dollar Amounts in Billions)

	Fiscal Year 1985				'Fiscal Year 1986			
Month	Commit's Issued	FY-to -Date	% of Cre Ceiling (68.250)	Commit's Out-standing	Commit's Issued	FY-to -Date	% of Cre Ceiling (65.313)	Commit's Out-standing
October	2.359	2.359	3.5	16.763	6.848	6.848	12.2	23.684
November	2.922	5.281	7.7	17.679	6.059	12.907	22.9	23.230
December	3.291	8.572	12.6	17.558	5.698	18.605	33.0	24.099
January	4.573	13.145	19.3	18.272	8.703	27.308	48.5	25.008
February	4.181	17.326	25.4	18.804				
March	3.756	21.082	30.9	18.474				
April	2.230	23.312	34.2	17.722				
May	6.073	29.385	43.1	18.933				
June	3.324	32.709	47.9	17.692				
July	9.085	41.794	61.2	21.830				
August	5.872	47.666	69.8	22.416				
September	6.927	54.593	80.0	22.468				
TOTAL	54.593	54.593	80.0					

	Securities Issued	FY-to-Date	Securities Issued	FY-To-Date
October	2.473	2.473	5.795	5.795
November	1.432	3.905	5.251	11.046
December	2.071	5.976	4.520	15.566
January	2.654	8.630	5.298	20.864
February	2.700	11.330		
March	2.771	14.101		
April	2.558	16.659		
May	3.595	20.254		
June	3.609	23.863		
July	3.859	27.722		
August	4.153	31.875		
September	4.403	36.278		

Prepared by: Secondary Market Activities RF/GAR
Mortgages Bankers Association

STATEMENT OF SGT. MAJOR C. A. (MACK) MCKINNEY

LEGISLATIVE COUNSEL

NON COMMISSIONED OFFICERS ASSOCIATION OF THE USA (NCOA)

Mr. Chairman. The Fiscal Year 1987 Defense Budget contains a request for $74.2 billion in appropriations for military personnel. According to the chairman, House Appropriations Subcommittee on Defense (HASD), this sum is about $2 billion greater than that for fiscal year 1986. The major increase results from the Administration's request for additional manpower; 14,000 for the active forces and 52,000 for the selected Guard and Reserve.

Using the HASD chairman's figures the additional personnel for FY 1987 could cost $500 million in FY 1986 dollars (based on average cost per servicemember in FY 1986), or about one-fourth the $2 billion increase referenced in the preceeding paragraph. Yet, there is a pay increase of 4 percent programmed for military personnel costing $2.6 billion. Apparently, since these two new items add to a $3.1 billion total there is a savings of about $1.1 billion somewhere in the Department of Defense (DoD) outlays for earlier years. The difference is shown on the following page.

SUMMARY OF BUDGET REQUEST FOR ACTIVE AND RESERVE FORCES

(In millions of dollars)

Fiscal Year 1986

	Enacted	Proposed sequestration and transfers	Total Fiscal Year 1986	Fiscal Year 1987	Change
Active Forces	$59,610	$3,894	$63,504	$64,738	+ $1,234
Reserve Forces	8,296	358	8,654	9,465	+ 811
Total	$67,906	$4,252	$72,158	$74,203	+ $2,045

Fiscal Year 1987

	Pay Hike	(Est.) Cost Added Manpower	(Est.) Total	Change	(Est.) Difference
All Forces	$2,600	$510	$3,110	$2,045	$1,065

Note: All figures above except those estimated "(Est.)" are quoted from the HASD chairman's remarks printed in the CONGRESSIONAL RECORD, February 5, 1986, pp H 351-354

NCOA believes much of the difference is derived from savings related to costs paid in 1985 and 1986 directly to military retirees and their survivors. U.S. Treasury figures show an actual decrease in costs during 1985 amounting to $670 million. Another $400 million-plus may be realized in 1986 if the cost-of-living adjustment (COLA) to retired pay and survivors benefits is not paid. The total savings is about $1.07 billion.

Wherever the difference is credited, NCOA is concerned that any reduction in the FY 1987 military personnel account, triggered by the Gramm-Rudman-Hollings budget legislation or by a cost-conscious Congress, may cause DoD to seek a decrease in active-duty year-end strengths. Hardest hit would be the enlisted corps, many of them with five or more years of credible service. For them there is no severance or rehabilitation pay.

Some years ago NCOA attempted to have Congress address the blatant and inequitable practice of offering severance or rehabilitation pay to the majority of its federal workforce, including commissioned officers of the uniformed services of the United States and foreign employees, but not to enlisted personnel of the Nation's armed forces. A number of Congressional bills were sponsored in the Senate and House, but oversight committees refused to hear arguments for consideration.

DoD said it couldn't support the legislation because enlisted personnel could "cash-in" up to 60-days unused leave at the end of every enlistment. Officers could not. However, in the mid-1970s the law was amended limiting "cash-ins" for enlisted personnel the same as for commissioned officers. "Now," said NCOA, "severance pay for enlisted personnel can be addressed."

But it wasn't. DoD and then some-incumbant committee chairmen made the excuse that severance pay was really a subject to discuss only when the military retirement issue came up again in Congress. They stuck by this half-baked reason even after the Defense Officers Personnel Management Act (DOPMA) was adopted a few years later. The amount of severance pay for commissioned officers went from a maximum of $15,000 to $30,000. Still there was no relief for discharged enlisted members with the same number of years of honorable service as may be required of the officers to qualify for severance payments.

Even today- some ten years after enlisted personnel lost eligibility to "cash-in" 60 days of unused leave at the end of each enlistment- there is no severance pay for them. Last year, when DoD submitted the two options prescribed by Congress to change the military retirement system, neither one addressed severance pay for enlisted personnel.

Because there is a probability the defense budget will be cut, the military services may resort to reductions in active manpower to offset losses in FY 1987 personnel appropriations. NCOA urges your distinguished panel to approve the personnel request and look elsewhere in the DoD budget to reduce funds, if such reductions are mandated. NCOA believes that procurement funds, particularly those for some strategic weapons and naval ships, can be cut or delayed so the Nation can maintain the positive manpower readiness capability it enjoys today.

Hopefully your colleagues will agree that in the absence of law addressing the severance pay issue for enlisted personnel and because the current force has displayed outstanding performances in accomplishing its missions, no reductions in appropriations for the active forces should be considered. However, funds requested to add 14,000 active duty and 52,000 reservists should be diverted to pay military retirees and their survivors a cost-of-living adjustment (COLA) in FY 1987- one that was unfairly denied them in 1986 and not included in the Reagan budget for 1987- and to help retain the current military retirement system.

NCOA believes it is imperative that Congress support the COLA over the President's objection. Further deterioration of promised retirement entitlements will adversely affect the current forces. Experienced and highly-qualified personnel will do what their older comrades did in the 1970s- vote with their feet. The Nation can ill-afford a reincarnation of those days, then later appropriate more funds to rebuild the damages done earlier.

Deterioration, by the way, also includes any adverse changes in the current military retirement program, even if it may be grandfathered. Servicemembers are well-versed in congressional actions reducing military retired pay benefits ever since Congress changed to the COLA system in 1963. They won't buy the "grandfather" premise anymore than they believe today's Congress will keep its promises to current military retirees. Thus, NCOA asks Congress to fully fund the military retirement accrual account to cover future costs of military retirement at current compensations, as contained in Title 10, United States Code.

In his Fiscal Year 1987 report to Congress, Secretary of Defense Caspar Weinberger begins by stating: "Debate about the defense budget, especially in an era of deficits, rarely focuses on the big picture. Too many of us cannot see the forest for the trees. Even worse, some of us get caught up in the leaves. In an effort to help us all keep some perspective on the forest, let me identify the four central questions each of us should ask ourself in thinking about U.S. defense programs and budgets."

Mr. Weinberger proceeds with the first three questions then states the fourth is rather difficult to answer- whether our defense budget is being spent wisely and effectively? He falters in providing a response to which is most effective for the price tag, is it wiser to spend money on people or weapons?

NCOA Unequivocally states that the answer is people. The current chairman of the House Committee on Armed Forces apparently agrees for he said late last year that an analysis of the $1 trillion spent on defense over the past four years shows a dramatic improvement in personnel. Further, he said, that improvement was "the only unqualified success." All other military capabilities, he noted were "at best, marginal."

Even more convincing should be the statement made years ago by the late General George S. Patton, Jr.- "Wars may be fought with weapons but they are won by men."

PVA
PARALYZED VETERANS
OF AMERICA
Chartered by the Congress
of the United States

STATEMENT OF

R. JACK POWELL, EXECUTIVE DIRECTOR

PARALYZED VETERANS OF AMERICA

BEFORE THE

SENATE COMMITTEE ON VETERANS' AFFAIRS

CONCERNING THE

PROPOSED FISCAL YEAR 1987 VETERANS ADMINISTRATION BUDGET

FEBRUARY 20, 1986

Mr. Chairman and Members of the Committee, I am R. Jack Powell, Executive Director of Paralyzed Veterans of America, and I want to thank you for affording me the opportunity to appear here today.

PVA appreciates the Committee holding this hearing, and for being able to express our views and concerns regarding this most important issue, the Administration's proposed Fiscal Year 1987 Veterans Administration Budget.

As you know, all of PVA's members are veterans who have experienced spinal cord injury or dysfunction, and it is on behalf of these veterans who have considerable contact with the VA's Regional Offices and Medical Centers located throughout the United States that we present our views today.

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Mr. Chairman, the budget proposed for the Veterans Administration for Fiscal Year 1987 is, without a doubt, the most deplorable attack on veterans and the programs and benefits which have been established to meet their needs. In past years we have found shortcomings in proposed VA budgets, but never have we seen such a blatant abdication of the nation's responsibility to the men and women who have rendered service. This budget proposal is more than an effort to curtail federal spending and reduce the deficit, it is an overt effort to eliminate veterans' benefits and preclude veterans' access to needed services, particularly in the the area of medical care.

The proposed budget purports to be a reduction of $408 million below the current year, including $234 million sequestered under the provisions of the "Balanced Budget and Emergency Deficit Control Act of 1985." However, upon examination of the proposals contained within the Fiscal Year 1987 VA budget, it becomes obvious that benefits and services for veterans will be reduced in excess of $1 billion. The budget proposal assumes the Veterans Administration will absorb the effects of inflation, the additional costs associated with cost-of-living increases in compensation, dependency and indemnity compensation (DIC), and pension, and salary increases for employees. All of these factors will drastically diminish the VA's capability to meet the requirements for adequately providing for veterans.

Over the past several years we have observed that budgets for the Veterans Administration were basically current services proposals, providing for no real growth in benefits and services. This year's budget proposal falls significantly below any such description and can be viewed only as an effort by this Administration to reduce the scope and availability of services and benefits for veterans. The Fiscal Year 1987 budget proposal for the Veterans Administration falls far short of meeting the current needs of veterans and fails miserably to adequately address future needs.

PVA recognizes the need to reduce the federal deficit, but in examining the proposed Fiscal Year 1987 VA Budget, we find the targeting of veterans' health care and services as a source of spending cuts and deficit reduction to be a reprehensible approach and disservice to the men and women who have served the nation.

Historically, this country has cared for its veterans. This huge task cannot be left to state and local governments which are not equipped for such an effort, and are already overburdened. The cost for providing for our nation's veterans is an obligation that is associated with the continuing cost of our national defense.

Mr. Chairman, this year, the nation's 28 million veterans, and their 54 million dependents and survivors will have to rely more than ever upon the wisdom and energies of this Committee, and Congress as a whole, to secure adequate funding for the programs and services administered by the VA. Repeatedly, Congress has had to struggle to add funding to proposed VA budgets that were patently insufficient to meet the needs of the nation's veterans, and the task this year will certainly be as challenging as any we have witnessed during the past several years.

The Federal budget that is submitted to Congress each year defines our nation's values and establishes the President's priorities. The nearly $1 trillion budget proposed for Fiscal Year 1987 represents a retreat from our commonly held values, disregards this nation's and Congress' approach for dealing with the deficit and certainly misplaces priorities. If the budget that was submitted to Congress were enacted, as proposed, more that $20 billion in additional reductions would be cut from already curtailed domestic programs that this administration has continually cut since 1981. At the same time, under the banner of national security, military [illegible]nding would increase 8 percent, by more that $34 billion in budget authority.

We all share a concern and a commitment to national security, but simply throwing more and more money at the Defense Department is not necessarily going to provide Americans with the defense they expect. The scandalous abuses of military spending that have been uncovered in the past two years clearly demonstrate the inability of the defense community to exercise any efficiencies in effectively administering these increased levels of budgetary authority. Yet, to finance this relentless build up, the American people are asked to accept greater sacrifices and absorb deeper cuts in domestic programs.

The operating budget proposed for Fiscal Year 1987 for the Veterans Administration is just one example of the many programs that have been offered up as sacrificial fodder. As former members of this nation's military service, veterans cannot and will not tolerate the continued reduction in benefits and services which this grateful nation obligated itself to provide us. This obligation was not made under duress. It was not conceived as a great social program, it was provided out of appreciation for the service, the sacrifice and in many cases, for the personal injuries that we, as citizen soldiers incurred in defense of our nation's ideals. Now, under the guise of fiscal constraint, we veterans are supposed to be content with less than that which was promised. We are to forget our fellow serviceman, those who did not hesitate to give their full measure when asked to fight.

The federal deficit problem is of concern to each and every American, veterans included, but the astronomical deficits that have accumulated over the past five years of the Reagan presidency are not of our doing and we are not willing to allow you or the Administration to forget the obligations and responsibilities incurred by previously enacted legislation benefiting veterans, their families, and their survivors.

The Veterans Benefits and Services function of the federal government, as administered by the Veterans Administration, has increased by approximately 25 percent since 1980, with outlays rising form $21.2 billion to $26.4 billion in the 1987 budget request (House Budget Committee statistics). On the surface this amount may seem adequate, and compared to other nondefense related programs, veterans certainly have not fared as badly as most. Still, one must remember the more than fifty-year mission of the VA, that being "to serve America's veterans and their families with dignity and compassion and to be their principal advocate in ensuring that they receive the care, support and recognition earned in service to this nation."

This they have attempted to do over the years, but recently veterans and certainly you, as members of Congress must be wondering if the role of the VA has not been usurped by a small band of pencil pushing, number crunching, administration surrogates housed in the Office of Management and Budget, who without concern, save for spending a buck, coldly and dispassionately cut this program and that.

Medical Care

Mr. Chairman and Members of the Committee, the most devastating single component of the Fiscal Year 1987 VA budget proposal is in the area of health care. No VA service provided to veterans is more critical or important to their well-being, and in many cases, their very survival, than health care. The callous proposal in the budget to reduce inpatient episodes of care by 57,354 and outpatient episodes of care by a staggering 1, 114,000 is beyond comprehension. Such a proposal highlights a total disregard for the nation's commitment to veterans.

The reductions in the number of inpatient and outpatient episodes is to be achieved by treating fewer "low priority veterans." The budget fails to define or identify who these veterans are and it assumes that the denial of care to these veterans will not be offset by the demand for care currently being denied some 30,000 plus veterans each month. This effort is clearly an attempt to constrict the VA health-care system and allow dollars, not need, to shape the scope and operations of VA medical care.

The VA requested $10.041 billion to provide veterans VA medical care. Despite this request, the Administration and OMB allowed only $9.083 billion for this important veteran benefit, and in so doing failed to provide monies for the thousands of veterans who are being turned away from VA health-care facilities each month. They failed to provide for the expansion of the GRECC's (Geriatric Research Education and Clinical Centers) as mandated by P.L. 99-166, and they apparently shifted responsibility for dealing with the aging veteran population onto the states in that medical care provided in non-VA facilities is the only subaggregate of the medical care account that would receive any new monies.

The budget proposal notes that the funding levels requested will provide for the maintenance and operation of all existing VA health-care facilities. While physical structures may remain, services certainly will be diminished. The budget proposal which calls for the loss of over 7,500 FTEE's in medical care, including 1303 nurses and 475 physicians, assumes only a reduction in quantity of services provided. PVA contends that quality will also be reduced with the elimination of such a significant number of FTEEs involved in direct medical care.

Without these medical care personnel the VA is going to be very hard pressed to address the specific and emerging special program areas of: services to aging veterans; female veterans; Vietnam veterans; veterans exposed to Agent Orange and Ionizing Radiation; former Prisoners of War; and of particular concern to us, certain VAMCs may not be able to provide the highly specialized care and rehabilitative service to those veterans who are paralyzed due to spinal cord injury or disease. We have testified on numerous occasions that the VA system of 20 medical centers that specialize in spinal cord injury are unparalleled in this nation for their combined expertise and concern. It is incumbent to maintain the VA medical care account at a funding level that most adequately serves the needs of all veterans, both now and in the future.

In regards to the number of veterans eligible for VA health-care services, the VA estimates that under existing legislation, 11,984,000 could, if they so desired, qualify for care. Of this population pool, only about three million veterans availed themselves of VA medical care in 1984. Last year the Administration proposed legislation to implement a "means test" for health care eligibility. That proposal was very inequitable but a more realistic "means test," disconcerting as the concept is, was finally ironed our and agreed to by the Committees on Veterans' Affairs, Mr. Chairman, only to be denied realization because of a reconciliation stalemate over Superfund.

Hopefully, Mr. Chairman, the earlier adopted version of a "means test" can be pulled from existing legislation and enacted in lieu of the Administration's test. Our concern for implementation of an equitable "means test" stems from the VA's Fiscal Year 1987 projected budget savings of more than $350 million and 6,988 FTEEs that purportedly will be realized by treating fewer "low priority veterans." We not only challenge the legitimacy of this cost savings, we fail to believe that the integrity of the VA health-care system can be maintained with such cuts in personnel and changes in patient mix.

In addition, we challenge the VA's or OMB's assumption that another 1,939 FTEEs and $57,200,00 can be realized through increased productivity in the medical care account during Fiscal Year 1987. We do not mean to imply there are not operations which cannot be improved or FTEEs who cannot be more effectively utilized, far from it, but it is high time that this Administration realize what an efficient health-care delivery system it has operating within the Veterans Administration. According to the figures contained within the House Budget Committee's analysis of the 1987 budget, VA hospital and medical care costs have only risen approximately 50 percent, while demand has increased since 1980. This indicates a cost-effective system compared to the private sector where the cost of a hospital room alone has increased by 63.2 percent and doctor fees have increased 46.3 percent over the same time frame, according to figures recently released by the Bureau of Labor Statistics.

VA Medical and Prosthetic Research

Another area of the VA budget with which we are very much concerned lies in the area of medical and prosthetic research. The $226,634,000 that was expended in Fiscal Year 1985 for this vital investment in the future care and rehabilitation of severely disabled veterans represents less than 1/10th of one percent of the total VA budget; yet, this account took a nearly 18 percent or a $40 million cut in Fiscal Year 1986 budget considerations. Now, seven months into Fiscal Year 1986, the President proposes to restore the $7,885,000 lost to sequestration back into this account in the coming year, but the research will be performed by 285 fewer FTEEs than were available last October. We view this unstable fluctuation of both funding and staffing as a devastating approach to maintaining the integrity of the VA's highly sophisticated, highly client-oriented research programs.

Granted, as has been the case over many, many years, when monetary funds become scarce, research activities, especially those that do not hold promise of an immediate return on investment, are curtailed or in some cases terminated. We are very concerned that the VA's research efforts into central nervous system disorders such as spinal cord injury, disease, and regeneration will be seriously disrupted. Such vacillation of commitment toward the one ray of hope and cure for the insidious ramifications of the many, as yet, unexplained medical phenomenons, we view as being penny-wise and pound-foolish. The VA's list of "Who's Who" in medical and prosthetic research is extensive as well as impressive, and the benefits that are and can be realized by their combined expertise should not be taken lightly. We request that additional monies be channeled into this important portion of the VA's Fiscal Year 1987 budget, especially as it pertains to the VA's targeted high priority research which includes spinal cord injury and tissue regeneration.

Personnel

Another aspect of the proposed Fiscal Year 1987 budget that is of concern to PVA lies in the VA Central Office's approach to maintaining critical manpower needs. We must question the rationale for all the reorganization proposals that have been submitted. We feel, this year, more so than in years past that the Veterans Administration has given up in their fight to advocate for the real needs of veterans and has instead decided that its new mission should be to maintain itself, meaning those bureaucratic functions that best serve that Administration, rather those that best serve the veteran population. This is harsh criticism to levy at the one agency within the federal government that is charged with the mandate of providing for veterans, and maybe after all the continuous assaults by this Administration to pare down the size of the federal government and shift more and more functions and responsibility to the state and local segments of our society, the VACO has assumed a "bunker mentality" and is engaged in a new mission of protecting its own employees at the cost of providing veteran services.

A prime example of this reprogramming of missions lies in its formation of the new Office of Facilities. When the budget proposes such drastic cuts in overall VA construction, it is difficult to understand why 733 FTEEs are needed to supervise a reduced function, whereas, without hard data to support the reduced need for hospital medical personnel, namely 1,303 nurses and 475 doctors, they choose to let these people go. We have been informed that certain of the nearly 7,500 FTEEs scheduled for termination in the medical care account are to be absorbed into this new Office of Facilities. This is good for those affected employees, but how will this reprogramming aid in service to veterans?

Another example of VACO entrenchment was their handling of the "sequestration order" that was recently issued by the President. In this situation the VA opted to reduce the amount of monies available for specially adapted housing, auto grants and adaptive equipment, all direct benefits to veterans, rather than lay off personnel within that line-item function that could result in a comparable cost saving. Again, the question must be asked — has the VA given up its role as chief advocate for veterans and is it now more concerned in trying to maintain the status quo among its own bureaucratic rank and file?

Another directive that has surfaced, not contained within the actual Fiscal Year 1987 VA budget per se, but contained in OMB documents relating to the VA's 1987 passback, was the mention made of restricting VA health care to nonservice-connected veterans to a maximum of 500,000 episodes in Fiscal Year 1987. The OMB directive to the VA indicated that it would approve funding for 1,243,700 inpatient episodes of veteran care, and limit nonservice-connected veterans to 500,000 episodes. PVA finds this directive not only unrealistic, but totally immoral, unprincipled and possibly in violation of congressional intent. The concept of establishing health-care usage ceilings might be an acceptable planning practice in the sterile, compassionless setting of the OMB office; but, when the VA's own data reveal demographic and patient profiles that support a totally different patient mix, then we are left to assume that OMB is in an outright assault on the VA's ability to perform its mission.

VA Construction

PVA believes the VA's Fiscal Year 1987 proposed construction budget of $408 million in new budget authority, a reduction of over $208 million from 1986, clearly demonstrates that the Administration is continuing not to recognize (or to ignore) the importance of maintaining and building adequate facilities if the VA is to perform its assigned function.

Equally disturbing, or puzzling, is that while the VA's office of construction 1987 budget will be reduced by 34 percent from the previous year, and coupled with certain duties being taken over by another department, the construction employment level will increase by 49 FTEEs.

A newly constituted associate deputy administrator for management will now perform construction's independent facilities management and will be funded with 10 new FTEEs. In addition to all of this, an office of facilities, another brand new office created under reorganization, is requesting a funding level of $38.9 million and 733 FTEEs for 1987. It is hard to understand the Administration's or VA's rationale for the significant increase in FTEEs within construction and facilities management, when little or none is taking place.

The needs of the aging veteran population will continue to place an ever growing demand on the VA's health-care delivery system, escalating an already critical situation. It is a very serious matter that so many VA facilities are now in a state of decay, only marginally meeting the needs of the veterans who use them. In previous years, testimonies given by veterans' service organizations and the Department of Medicine and Surgery indicated that over half of all the beds located in VA facilities are in buildings 35 years old or older. Decaying facilities not only diminish efficient patient usage, they also hamper the recruitment and retention of qualified doctors and nurses.

The coming impact of the aging veteran had been a responsibility which the Veterans Administration was taking seriously. Now the VA has determined to shift its mission, by restructuring its long-term care policy, relying on the states and their communities to furnish the necessary facilities for providing care.

While the proposed Fiscal Year 1987 funding for grants for construction of state extended care facilities provides an increase of over 100 percent from the current year, the funding for the construction of VA nursing homes has been reduced by 82 percent.

The VA funding to assist the states in the acquisition or construction of state nursing homes or the remodeling, modification, or alteration of existing state veterans' homes has increased to $42.4 million in 1987, up over $21.6 million from the previous year level of $20.8 million. This drastic increase in funding is somewhat unrealistic when keeping in mind the necessary planning, and restrictions that states must adhere to, not to mention the necessary funding they must secure, before such a facility can be obtained or constructed. It is apparent that more and more of the solutions to problems are being shifted to the states from the federal government. This is just one more situation evident today where the federal government is relying on the states, which are already overtaxed and overburdened, to assist in solving a critical shortage in providing for our nation's aging veterans. A task that is not rightfully theirs.

Veterans' Benefits

Mr. Chairman, the area of readjustment benefits is an issue of concern to PVA as proposed in the Fiscal Year 1987 VA budget. The Administration proposes to eliminate or significantly curtail numerous programs and services for veterans regardless of their obvious benefit and need. The new G.I. bill has already proven itself as a viable educational asset for veterans. The exceptionally high participation rate has significantly been of value to the military and, more importantly, will have long lasting benefits for individual veterans and the nation as a whole.

The failure to provide funding for the "Emergency Veterans' Job Training Act of 1983" is equally disconcerting. While unemployment may have decreased for certain segments of society, for those veterans without jobs, the need for this program still exists. There remain thousands of unemployed, eligible veterans who have been certified for training under this program, but who have not entered actual training. To eliminate funding when the economy's recovery offers these veterans their greatest opportunity seems to be inappropriate and counterproductive.

Another issue of concern to PVA's members is the Administration's attempt, within the proposed 1987 budget, to dismantle the VA's Home Loan Guaranty Program. Again, legislation is being considered this year, raising the current "users fee" from 1 to 2 percent, eventually rising to 3.8 percent by 1990.

The VA's Home Loan Guaranty Program is an entitlement program, with every veteran meeting the requirements being eligible for a guaranty of their mortgage up to 60 percent of the loan or $27,500, whichever is less.

PVA believes than an increase in the "user's fee", if enacted, would have a serious detrimental effect on the ability of veterans to obtain guaranteed loans, and thereby discourage veteran's home ownership. By raising the origination fee, veterans using their guaranty entitlement would either have to pay the increased fee up front, or have the fee added on to the loan.

This would result in a veteran needing a substantial amount of cash on hand, or add the users fee into the loan, thereby increasing the amount of the mortgage and exceeding the actual property value.

Equally disturbing within the VA's Home Loan Guaranty Program is the VA's plan to reduce the maximum guarantee by over $45,000, and to discontinue refinancing, while at the same time home prices continue to rise, both as a result of Gramm-Rudman.

Without a doubt, the VA Home Loan Guaranty Program, having assisted over 11 million veterans in obtaining suitable, affordable housing, has been one of the most successful in this nation's history. This program has been a good investment in America, providing stability and expanding the tax base of nearly every community in our country.

Mr. Chairman, the Fiscal Year 1987 budget proposal does provide for a cost-of-living increase in compensation, dependency and indemnity compensation and pension. This is one positive aspect of an otherwise bleak budget proposal. These cost-of-living increases will ensure that veterans and their survivors will not see their quality of life eroded by the effects of inflation. However, these proposed increases are achieved through the reduction of other benefits and services provided by the Veterans Administration.

Finally, PVA would be remiss if we did not address the VA's recent approach to achieving savings mandated through sequestration. Effective March 1, 1986, there will be a reduction in readjustment benefits paid to those veterans who are the more severely disabled, service-connected veterans. Vocational rehabilitation subsistence allowance, paid to those service-connected veterans who are in training, is cut over 13 percent. The grant for specially adapted housing, payable only to those veterans who are permanently and totally disabled is cut $2840. The grant to a service-connected veteran for the purchase of an automobile or other conveyance and/or to adapt one with necessary special equipment is cut $400.

This approach is abhorrent and reflects the insensitivity to and callous disregard for the service rendered by these eligible veterans. The VA demonstrated a willingness to reduce benefits for the most seriously disabled service-connected veterans rather than explore other methods for achieving the same savings.

This recent effort and the Fiscal Year 1987 budget proposal seriously call into question the esteem and regard which this Administration affords the nation's veterans and their past service. Hopefully, this Committee and the Congress will, as they have in the past, continue to honor and uphold the nation's obligation.

Mr. Chairman, that concludes my statement. Thank you and the Members of the Committee for your thoughtful consideration of this issue, and I will answer any questions that I can.

Testimony of José A. Ortiz-Daliot
Director
Puerto Rico Federal Affairs Administration

The Effect of Federal Government Budget Cuts on Puerto Rico

March 12, 1986

My name is José A. Ortiz-Daliot. I am the Director of the Puerto Rico Federal Affairs Administration, which is the office of the Governor of Puerto Rico in Washington. My purpose in presenting this testimony is to acquaint you with Puerto Rico's economic situation and how its being adversely affected by continuing reductions in federal government programs. Most specifically I would like for you to know how Puerto Rico would be hurt by serveral proposed reductions in the fiscal year 1987 budget of the Administration.

In 1984 a study done for the American Federation of State, County, and Municipal Employees reported that Puerto Rico ranked third in the nation in per capita losses in federal aid over the previous three years. We led the nation in losses in such areas as nutrition assistance, employment and training, and assistance to the educationally deprived. That Puerto Rico should be hit hard by federal expenditure cuts is a natural consequence of a national policy of retrenchment in social programs which aid the poor. In spite of tremendous economic advances made during the 1950s and 60s Puerto Rico remains the poorest jurisdiction of the United States by a substantial margin. The 1980 U.S. Census reported that the median family income in Puerto Rico was $5,923 which is only 26 per cent of medium family income in the United States. Over 62 per cent of the population lived below the federal poverty level versus slightly more than 10 per cent of the population in the United States. Since 1980 conditions have worsened as the unemployment level has climbed from 17 per cent to a yearly average of over 20 per cent in 1985. Average family income, in real terms, was about the same in Puerto Rico in 1985 as it was in 1973.

One of the consequences of this economic stagnation while natural population growth continues has been increased migration to the mainland. In the decade of the 1970's the number of Puerto Ricans living in the mainland grew by some 600,000 to 2,014,000, or by 41 percent. In Puerto Rico the population grew by 474,000 to a total of 3,184,000, or by 17.5 per cent.

When Puerto Rico experienced its worst recession since the Great Depression in the mid-1970's the blow was cushioned to a certain degree by a rise in federal expenditures for social programs. In the 1980s, declines in the private sector have been accompanied by reductions in the public sector.

These trends continue with the fiscal year 1987 Administration budget. As an example, in the area of construction, Puerto Rico has experienced a serious decline since the early 1970s with an employment reduction from 80,000 to 34,000 jobs. A substantial part of remaining jobs have been accounted for by projects under the Urban Development Action Grant program which brought more than $40 million badly-needed dollars into Puerto Rico's economy in 1984. That program is slated to be eliminated in the fiscal year 1987 budget. The Farmer's Home Administration, which provided almost $100 million in loan guarantees in Puerto Rico in 1985, is also recommended for elimination, and this would also have a serious negative effect on the construction industry as would elimination of rural waste water disposal grants and the phasing out of waste water construction grants.

In the field of education, Puerto Rico would also experience large reductions in Pell Grants, Supplemental Education Opportunity Grants and the Vocational Education Basic State Grant. Other proposed cuts which would weigh heavily on Puerto Rico are in Community Development Block Grants, the Summer Youth Employment Program, and the School Lunch Program. Proposed program eliminations which would have the greatest effect, other than those previously mentioned, would be the Small Business Administration, the Community Services Block Grant, and a substantial part of the Agricultural Extension Service. These programs are not mere handouts. They are designed to assist Puerto Rico to be more productive and to provide for its own well being under very difficult circumstances.

The greatest single setback to Puerto Rico contained in the 1987 budget is the recommendation that the $27.75 million increase in Puerto Rico's Nutrition Assistance Program (NAP) that was legislated last year along with a yearly inflation adjustment formula be set aside leaving Puerto Rico with the $825 million amount which it has had to live with since July of 1982. This rigid block grant which was instituted when Puerto Rico was removed from the food stamp program has forced the Government of Puerto Rico to lower the eligibility levels for a typical family of four from $11,000 to $8,000 in annual gross income and has resulted in the removal of 113,000 households from the program. At the same time, the eligibility level under the National Food Stamp Program has risen to over $13,000. The maximum monthly benefit under NAP for a family of four is only $199; lower than the $221 benefit provided during the last year of the Food Stamp Program in Puerto Rico. The maximum monthly benefit under the Food Stamp Program on the mainland increased from $233 in 1982 to $264 in 1985.

Food prices are higher in Puerto Rico than on the mainland and, since 1982, they have increased at a rate that is at least as great. Merely to compensate for the increased food costs through 1985 would require an increase in the NAP of over 10 per cent. To bring NAP benefits -- which in their first year were 25 per cent less than they would have been under Food Stamps -- up to the 1987 Food Stamp level would require an increase of over 40 per cent. As it is, Puerto Rico is allowed a 3.36 per cent increase under current law.

To take away this small, long overdue increase would be the gravest injustice to Puerto Rico and we strongly urge the Senate not to do so. Already

Puerto Rico is left out of such major program as Revenue Sharing and Supplemental Security Income and receives only partial funding under AFDC, Medicaid, and a variety of other programs. A continuation of the NAP funding freeze would ensure that the standard of living gap between U.S. citizens living in the mainland and those in Puerto Rico would continue to widen.

In additon to the problems for Puerto Rico that we foresee in the FY 1987 budget, we would like to call your attention to two reductions of payments to Puerto Rico in the FY 1986 budget which were highly improper and, we feel, inconsistent with the intent of Congress.

The first is the 4.3 per cent reduction in the federal excise tax and U.S. Customs duty transfers to Puerto Rico that was made by the General Accounting Office under their interpretation of the requirements of the Balanced Budget and Emergency Deficit Control Act. Since the First Organic Act of 1900 originally defined Puerto Rico's status relationship to the United States, these funds have been collected by the U.S. Treasury and turned over to the Government of Puerto Rico. Only as an administrative convenience do they appear as part of the budget. We urge the Senate to take whatever action is necessary to clarify this matter, to restore the funds that have so far been erroneously sequestered, and to ensure that the full cover over continues in the future.

A similar situation exists in the case of $4,950,000 that was cut by the Department of Agriculture from the Nutrition Assistance Program in December, 1985, as part of an across the board cut of .6 per cent of that agency's budget. In this case, also, we feel that the agency in question exceeded the mandate of Congress and that the funds rightfully should be restored. In every instance when the Congress has dealt with the NAP block grant, in 1982 when it was established (PL 97-253), when it was reauthorized by Congress in 1985 (PL 99-198), and again in the Balance Budget and Emergency Deficit Control Act of 1985 when it was exempted from sequestration, it has been clearly established that the block grant is a fixed amount not subject to reduction. Urgent action is needed here also to correct this obvious error.

We appreciate this opportunity to inform you of Puerto Rico's concerns about the federal budget and trust that they will be dealt with fairly and compassionately.

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